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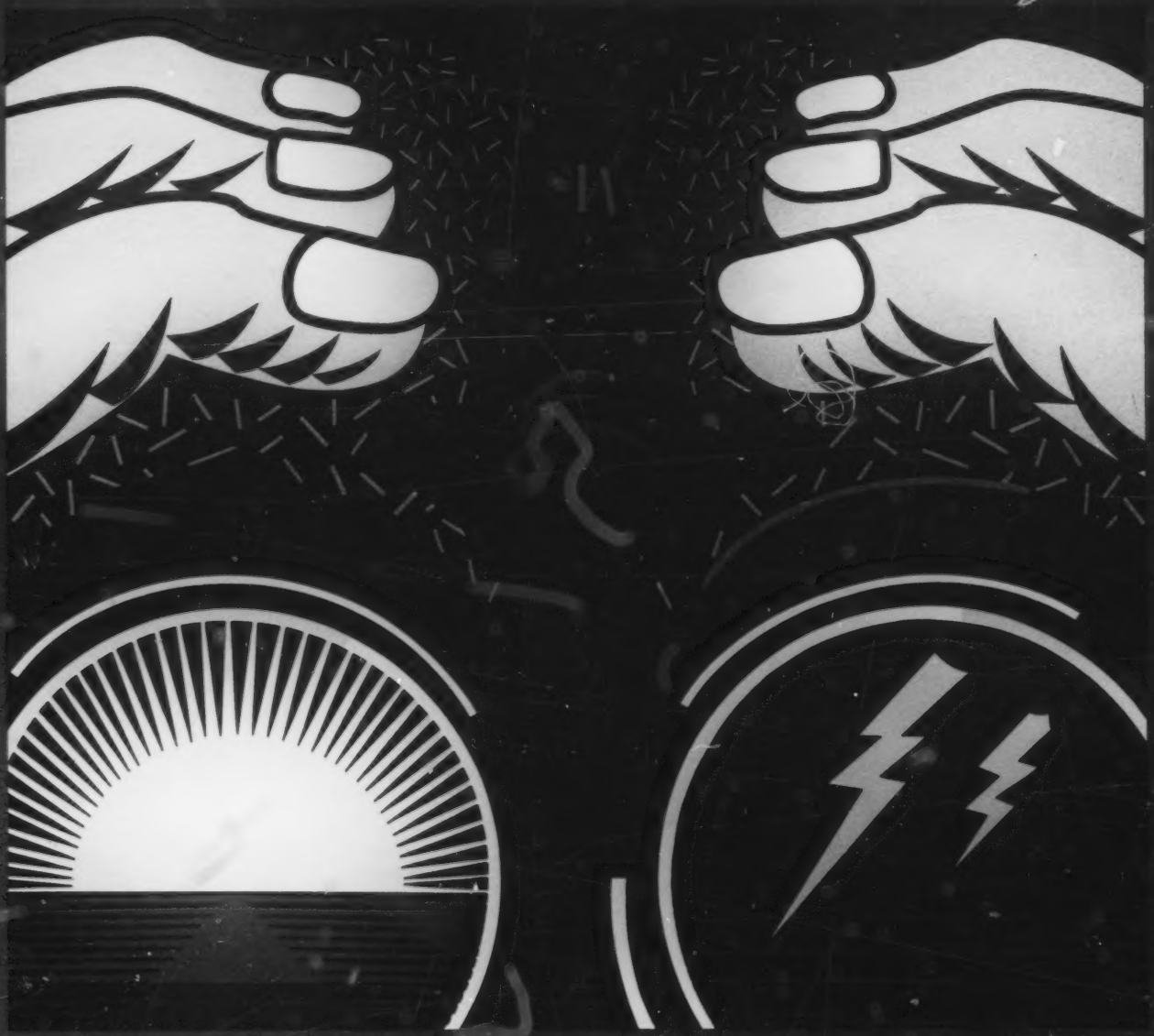
FORECAST
1991·1992



First Interstate Territory Edition

First Interstate Bancorp

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Overview

Uncertainty about the near-term economic outlook has been heightened by the crisis in the Middle East. While some forecasters now see stormy weather ahead, we do not believe that is the most likely outlook for the 1991-92 period.

The economy was already flirting with recession this year before Iraq invaded Kuwait. Weak final demand was pointing towards easier monetary policies at midyear. The short-term effects of the invasion, however, created the worst of all worlds for policymakers--higher inflation rates and rising unemployment.

Nevertheless, the road to greater prosperity in the 1990s has only taken a slight detour. From our point of view, the outlook for the period after the Middle East crisis is quite good. The slow economic growth from late 1989 through the first half of 1991 is helping to set the stage for further, solid expansion with little inflation in the years ahead.

Pre-invasion Outlook

Before the Iraqi invasion of Kuwait, most forecasters were revising downward their projections of real economic growth for the second half of 1990. The sustained restrictive policies of the Federal Reserve were holding growth below potential, while inflation rates were still viewed as unacceptable. Before the "oil shock" of August 1990, inflation this year was generally expected to have been about the same as 1989's 4.6%--higher than the Fed has said is acceptable. Even that rate, however, included the temporary effects of a run-up of oil prices early in the year.

After the Crisis

The prospects for 1991 and 1992 will be much more to the policymakers' liking--lower rates of inflation accompanied by faster growth of output and employment. By the end of 1991, we expect output to be rising at a 2.5-3.0% rate. At the same time, we expect consumer prices to rise by no more than 4% next year and interest rates to fall considerably from their oil-crisis highs.

Our forecast assumes the Middle East crisis is resolved before 1991 without major damage to oil facilities. We look for oil prices in 1991 to average in the range of $19 to $21 per

barrel, and then increase only about $1 in 1992. Inflation psychology will improve with lower oil prices, so nominal interest rates will trend down and boost investor confidence.

Lower market interest rates and a somewhat more generous Fed will enable the housing and auto sectors to post modest gains from their 1990 cyclical lows. We expect nonresidential construction to remain weak in view of the continuing excess supply of office space, hotels, and shopping centers in numerous parts of the country.

The strongest industries in 1991 will be concentrated in services, although pharmaceuticals, communications, and retail food stores should also show a favorable performance. Weakness will persist in construction, several of the manufacturing industries, rail and water transportation, S&Ls, and certain segments of retailing.

Export-oriented sectors of the U.S. economy performed well in 1990 and should remain strong in 1991-92. The spreading industrialization of Asian economies, the renewed vigor in some of the restructuring economies of Latin America, and the enormous demands for new physical plant and equipment in Eastern Europe and the Soviet Union suggest a long and healthy expansion for capital-goods and industrial-products firms. "Smokestack America" will like the 1990s much better than the 1980s.

Abroad, the central banks of Germany and Japan have tightened policy in order to head off potential rises in inflation. Despite relatively high real interest rates, economic growth in both countries--and in continental Europe generally--should be maintained at rates above those in North America during the coming two years. Higher growth and rising exchange rates will mean reductions in the large current-account surpluses of both Germany and Japan.

The U.S. trade deficit should decline moderately during the coming two years as a result of slower domestic growth, continued good growth abroad, and a weaker dollar through the first part of 1990. By 1992, the current-account deficit will be down to a relatively low 1.5% of GNP.

The strong relative performance of the western half of the United States economy in the past few years is expected to continue in the early 1990s. Growth of output, employment, and personal income has slowed along with the national economy in 1990 and will remain slower in 1991-92 than the exceptionally strong growth of 1988-89. However, slower growth is not a decline and also is not necessarily undesirable.

On balance for 1991-92, FI Territory states are expected to experience average employment growth of 2.1%, versus 1.4% for the nation as a whole. Similarly, personal income is expected to rise at a 7.1% rate during the two-year forecast period in FI Territory, compared with 6.3% in the nation.

The Pacific Northwest and the Rocky Mountain regions will record the highest employment growth rates in the Territory during 1991-92. Growth in the Rocky Mountains will represent a continued process of recovery, while performance of the Pacific Northwest will be a moderation from three years of very rapid gains.

--October 12, 1990

The U.S. Economy

The U.S. economy should begin to recover from its 1990 slump in 1991. The recovery will be moderate, with real GNP growth of 2.3%, compared with a gain of only 0.7% in 1990. We expect a further increase of 2.4% in 1992.

Housing and autos will begin to emerge from their lows of 1990, and business capital spending should resume a stronger trend by the end of 1991. Generally overbuilt conditions will dampen nonresidential building through 1991, but exports will expand further. Consumer spending will show moderate growth.

The federal budget deficit will exceed $200 billion in each of the three fiscal years, 1990-92, because of slower revenue growth and higher spending for failed thrifts. We expect Congress and the administration, however, to take steps over the forecast period to push the deficit lower.

The 6% leap in consumer prices in 1990, largely caused by the spike in oil prices, is expected to be temporary. Lower oil prices and the impact of past monetary policy should hold inflation to 4% or less during each of the next two years.

Moderate economic growth and lower inflation should cause 1991 and 1992 interest rates to average well below the levels of 1990. Unemployment will rise into the first part of 1991 and then fall. Corporate profits should begin to improve in 1991 after two years of decline.

Policies Confront New Complications

Iraq's invasion of Kuwait on August 2, 1990, made conduct of U.S. economic policy even more difficult. Suddenly, the leap in inflation concerns restricted the Federal Reserve's latitude for easing, while estimates of the federal budget deficit were already escalating. Although a high degree of uncertainty now exists, we believe that U.S. economic policy can assume a more even keel over the next two years.

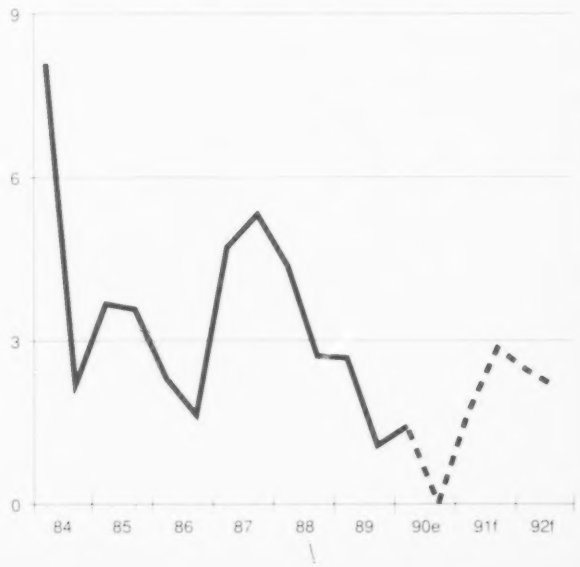
Monetary Policy--Striving for Price Stability

Federal Reserve policy has been generally tight since early 1987. Over the 3-1/2 years ending in mid 1990, the money supply measured in terms of M2 (currency, checking and savings accounts, and certificates of deposit less than $100,000) increased at an annual rate of only 4.7%. This contrasts with the rapid 8.7% average rate of increase during the prior three years.

The intent of U.S. monetary policy is clear: inflation is to be reduced, with stable prices the ultimate goal. Zero inflation should not be dismissed as an impossible objective. The United States experienced inflation averaging only about 1% during the early 1960s. Japan

Real GNP Stalls, then Recovers

(Percent change, annual rate, half-year average)



and Germany achieved essentially stable prices as recently as 1987 and recorded inflation rates of only about 1% in 1988.

As the American economy began the second half of 1990, the impact of restrictive monetary policy was evident. Real GNP had expanded at less than a 2% annual rate for five consecutive quarters, with growth averaging barely over 1% during the latest three quarters. This impact was not surprising since changes in monetary policy typically first affect output before prices, in part because inflationary expectations can prove to be relatively "sticky."

The Middle East crisis prevented the Federal Reserve from easing in August 1990 despite growing signs of a slowing economy. Soaring oil and gold prices, together with a falling dollar, revived inflation concerns. The Fed intends to avoid the mistakes of the 1970s when it tried to dampen the impact of the oil price shock through rapid money creation. The present Federal Reserve believes it is much easier to reverse a temporary slump in the economy than to quash an upsurge in inflation and inflation psychology.

If oil prices subside in 1991 as we assume, the Federal Reserve should be able to pursue a somewhat more expansive policy. We assume M2 growth of about 5.3% in 1991 and 4.6% in 1992, compared with the 4.1% increase estimated for 1990. Provided that inflation is stable or declining, monetary policy can be expected to prevent any economic slippage from deepening or becoming prolonged. Nevertheless, the long-term objective of price stability will not be abandoned.

Fiscal Policy--the Elusive Balanced Budget

The Balanced Budget Act (Gramm-Rudman-Hollings) specified a maximum budget deficit of $64 billion in fiscal 1991 (beginning October 1, 1990) and a balanced budget by fiscal 1993. The slowdown in economic growth and revenues, expenditures for failed thrift institutions, and military demands in the Middle East have scuttled any hopes of reaching those objectives. Congress can be expected to stretch the deficit reduction timetable.

Our estimates peg the federal deficit at about $236 billion for fiscal 1990. This total would compare with deficits of about $150 billion in each of the previous three years and a prior peak of $221 billion in fiscal 1986. For fiscal 1991, the slowdown in revenue growth is likely to push the deficit to about $257 billion. We expect deficit reduction to be back on track by fiscal 1992 with an easing to about $205 billion. The burden of dealing with the savings and loan issue will contribute an average of close to $70 billion to the deficit each year between fiscal years 1990 and 1992.

FEDERAL BUDGET DEFICIT

(Billions of dollars, fiscal year)

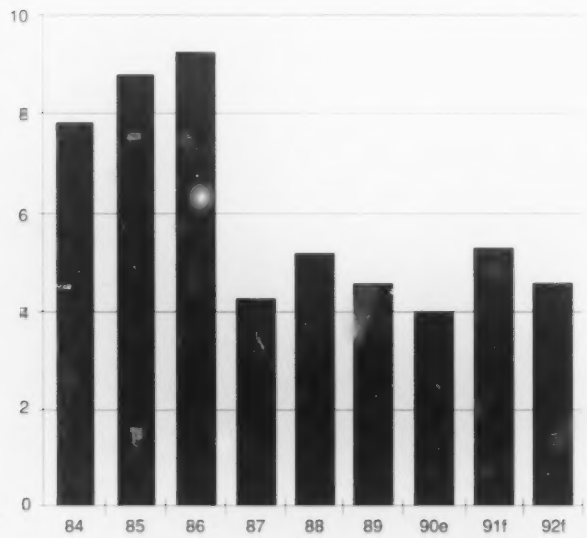
	Thrift Outlays	Deficit Excluding Thrift Outlays	Total Deficit
1988	8	147	155
1989	9	143	152
1990e	63	173	236
1991f	82	175	257
1992f	63	142	205

As fiscal 1990 came to a close, pressure mounted on Congress to reach an agreement to reduce the federal deficit. If the Middle East crisis continues to strengthen the political position of the President, the administration is likely to improve its bargaining position with the Senate and House. Significant budget actions calling for both spending cuts and tax increases over a period of years are likely to be achieved. A downturn in the economy could, however, blunt success in reducing the deficit significantly in the immediate future.

Although deficits in the $200-260

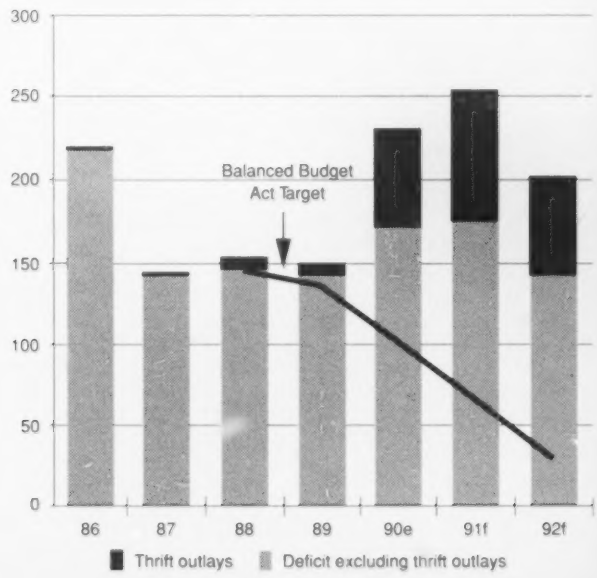
Fed Pursues Tight Monetary Course

(Percent change in M2, 4th quarter to 4th quarter)



Thrift Outlays Help Push Federal Deficit Higher

(Billions of dollars, fiscal year)



billion range are disturbing, it is important to place them in the context of an economy which will be producing more than $6 trillion of goods and services by 1992. The deficit will amount to an average of about 4% of GNP in fiscal 1990-92, in contrast to a high of over 6% in fiscal 1983.

Is the Expansion Over?

If the economic expansion continues into October 1991, the previous 106-month record of the 1961-69 upswing will be broken. Several signals have recently started flashing red, however, and concerns over a downturn have mounted. The Middle East crisis dampened consumer and business confidence at a time when employment and spending were already weak.

The National Bureau of Economic Research will ultimately decide if the current period is one of recession. The group's members must determine if any downturn is sufficiently deep, long, and widespread to be classified as an official recession. Regardless of the outcome, it is clear that certain parts of the economy are depressed--autos, housing, and nonresidential construction. Manufacturing jobs were reduced by a total of more than 450,000 between the peak of January 1989 and August 1990. At the same time, agriculture, export industries, and various services are holding their own, while the commercial aircraft industry continues to operate at a breakneck pace.

Our forecast is that the U.S. economic slump will be short and shallow. The economy is likely to show no growth on average in the last half of 1990, and real GNP may still be crawling along at only about a 1% pace in the first quarter of 1991. Growth should pick up, however, to about a 3% rate by the end of next year.

An easing in monetary policy, with lower interest rates and faster monetary growth, should help resuscitate the U.S. economy. Europe, the Far East, and, to some extent, Mexico will act as "growth locomotives" by supporting U.S. exports. The lack of widespread and massive inventory accumulation in the United States will cushion production and job cutbacks, which have typically accompanied inventory cycles.

Just as the slump in American economic activity will be comparatively mild, a recovery will be restrained. The debt loads of both consumers and industry will limit spending. The Federal Reserve will attempt to prevent the economy from growing faster than its potential, which it views as about 2.5% per year. The overhang of unleased office and other nonresidential property will restrict new activity in that sector.

On balance, we expect real GNP to rise 2.3% on a fourth-quarter-to-fourth-quarter basis in 1991 and 2.4%

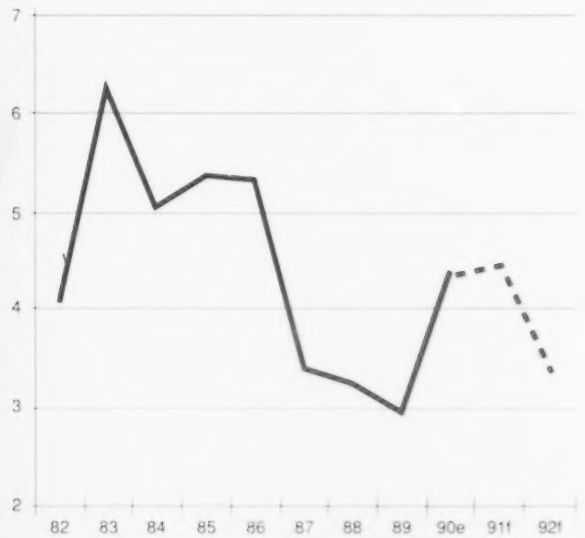
ECONOMIC MEASURES FROM DIFFERENT PERSPECTIVES

(Percent change)

	4th Quarter to 4th Quarter			Annual Average		
	Nominal GNP	Real GNP	CPI	Nominal GNP	Real GNP	CPI
1990e	5.5	0.7	5.0	5.4	1.0	5.4
1991f	6.3	2.3	3.9	5.7	1.4	4.4
1992f	6.1	2.4	4.0	6.4	2.6	4.1

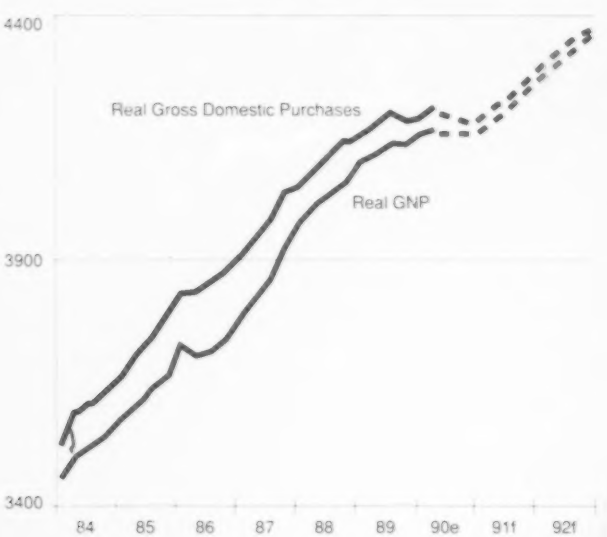
Temporary Rise in Deficit's Share of GNP

(Percent, fiscal year)



Spending Slows Relative to Production

(Billions of 1982 dollars)



in 1992. These growth rates would mark an improvement over the anemic 0.7% gain estimated for 1990. Fourth-quarter-to-fourth-quarter numbers, which give a better sense of the trend of growth during the year, will indicate a distinctly different picture than annual averages next year. Real GNP will be up an average of only 1.4% in 1991 before a gain of 2.6% in 1992. Our estimates place 1990's average growth number at 1.0%.

Key Sectors to Run at Different Speeds

Consumer confidence dropped sharply in August 1990 with concerns over a possible recession, inflation, and events in the Middle East. Retailers were forced into heavy discounting to generate volume increases of any size. We expect a moderate pickup in consumer spending in 1991 as the outlook for employment and income growth improves. Consumer spending will expand at a rate slightly less than the overall economy, with a fourth-quarter-to-fourth-quarter real gain of 2.2% in 1991 and 2.1% in 1992. In contrast, consumer spending is anticipated to end 1990 with a gain significantly less than 1.0%.

We expect 1990 to mark a cyclical low for the auto industry before a modest pickup occurs in 1991. Combined sales of cars and light trucks are

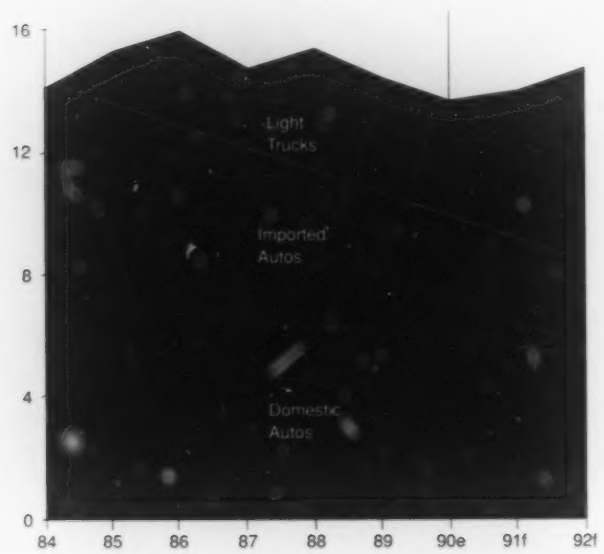
MAJOR ECONOMIC INDICATORS

	Quarterly 1990 I	1990 II	1990 III	1990 IV	1991 I	1991 II	1991 III	1991 IV
	Actual				Forecast			
GROSS NATIONAL PRODUCT (Billions of $, annual rate)	5375.4	5451.9	5513.5	5579.9	5655.1	5742.1	5834.6	5930.0
% Change, annual rate	6.7	5.8	4.6	4.9	5.5	6.3	6.6	6.7
REAL GNP (Billions of 1982 $, a.r.)	4150.6	4162.8	4159.8	4163.7	4176.7	4199.6	4227.6	4259.9
% Change, annual rate	1.7	1.2	-0.3	0.4	1.2	2.2	2.7	3.1
REAL FINAL DOMESTIC SALES* (Billions of 1982 $, a.r.)	4195.2	4190.0	4188.9	4188.3	4193.0	4209.8	4235.0	4263.9
% Change, annual rate	2.7	-0.5	-0.1	-0.1	0.4	1.6	2.4	2.8
REAL CHANGE IN INVENTORIES (Billions of 1982 $, a.r.)	-2.2	11.6	4.0	1.5	4.0	7.0	10.0	14.0
GNP DEFLATOR (1982=100)	129.5	131.0	132.5	134.0	135.4	136.7	138.0	139.2
% Change, annual rate	4.8	4.7	4.8	4.5	4.2	4.0	3.8	3.5
CONSUMER PRICE INDEX (1982-84=100)	128.3	129.5	131.5	133.3	134.5	135.8	137.1	138.6
% Change, annual rate	8.2	3.8	6.3	5.6	3.7	3.8	4.0	4.3
AUTO SALES (Millions, annual rate)	9.8	9.5	9.4	8.9	9.0	9.4	10.0	10.9
HOUSING STARTS (Millions, annual rate)	1.45	1.20	1.14	1.14	1.16	1.21	1.38	1.42
INDUSTRIAL PRODUCTION (1987=100)	108.3	109.4	109.5	109.6	110.0	110.7	111.5	112.4
% Change, annual rate	0.7	4.1	0.4	0.4	1.5	2.4	3.0	3.4
NONFARM EMPLOYMENT (Millions)	109.9	110.5	110.7	110.7	110.9	111.3	111.9	112.4
UNEMPLOYMENT RATE, ALL WORKERS (Percent)	5.2	5.2	5.5	5.9	5.9	5.7	5.5	5.3
ECONOMIC PROFITS AFTER TAXES (Billions of $, annual rate)	167.0	175.5	172.0	170.0	173.0	179.2	182.0	184.4
% Change over year ago	-6.7	-2.8	-3.9	1.5	3.6	2.1	5.8	8.5
MONEY SUPPLY M2 (Billions of $, a.r.)	3253.0	3276.4	3303.4	3331.9	3369.6	3419.1	3465.1	3509.3
% Change, annual rate	6.6	2.9	3.3	3.5	4.6	6.0	5.5	5.2

NOTE: All quarterly series are seasonally adjusted; % change, annual rate calculated from prior quarter; calculations based on unrounded data; a.r. = annual rate. *Excluding Commodity Credit Corp. purchases.

Auto Market Drives Off its 1990 Low

(Millions of units)



1992 I	1992 II	1992 III	1992 IV	1990	% Change '90/'89	4th Quarter 1991	% Change '91/'90	1992	% Change '92/'91
Forecast				Estimate		Forecast			
6025.5	6115.3	6205.1	6294.6	5579.9	5.5	5930.0	6.3	6294.6	6.1
6.6	6.1	6.0	5.9						
4288.4	4313.0	4337.7	4360.5	4163.7	0.7	4259.9	2.3	4360.5	2.4
2.7	2.3	2.3	2.1						
4290.0	4312.0	4333.2	4353.5	4188.3	0.5	4263.9	1.8	4353.5	2.1
2.5	2.1	2.0	1.9						
16.0	18.0	20.0	21.0	1.5	N/A	14.0	N/A	21.0	N/A
140.5	141.8	143.0	144.4	134.0	4.7	139.2	3.9	144.4	3.7
3.8	3.7	3.6	3.7						
140.1	141.4	142.8	144.2	133.3	6.0	138.6	3.9	144.2	4.0
4.5	3.8	3.9	4.0						
10.4	10.2	10.2	10.1	9.4**	-4.9	9.7**	2.7	10.2**	5.6
1.43	1.44	1.45	1.45	1.23**	-10.4	1.29**	4.7	1.44**	11.5
113.2	113.9	114.6	115.3	109.6	1.4	112.4	2.6	115.3	2.5
2.8	2.5	2.5	2.4						
113.0	113.4	113.9	114.2	110.7	1.3	112.4	1.6	114.2	1.6
5.3	5.2	5.2	5.1	5.9	N/A	5.3	N/A	5.1	N/A
188.0	191.4	194.2	197.0	171.1**	-3.0	179.7**	5.0	192.7**	7.2
8.7	6.8	6.7	6.8						
3550.7	3590.8	3630.6	3669.9	3331.9	4.1	3509.3	5.3	3669.9	4.6
4.8	4.6	4.5	4.4						

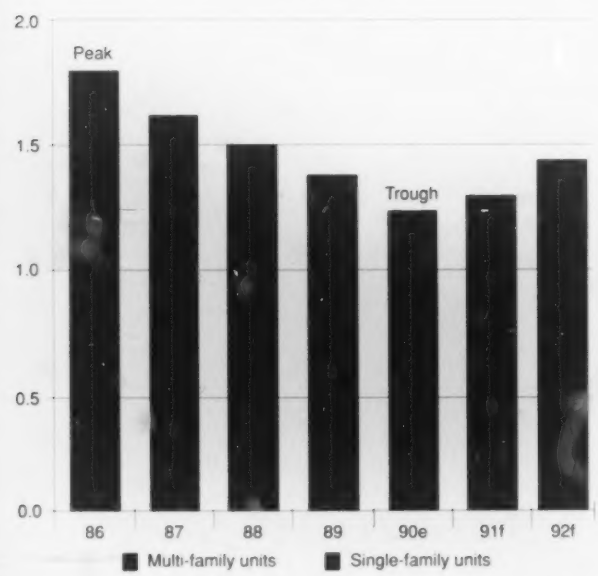
**Annual total. N/A = Not applicable

likely to total only 13.8 million units for all of 1990, the lowest level since 1983. Unit sales should improve to 14.1 million in 1991 and then to 14.8 million by 1992. Japanese auto makers will continue to shift production to the United States.

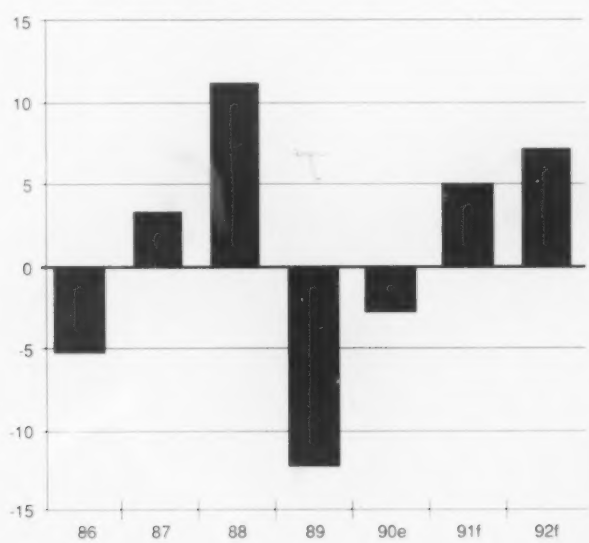
We also expect housing to begin to emerge from the doldrums of 1990. Housing starts are likely to total less than 1.25 million units for 1990, the worst showing since 1982. Although 1991 will remain a relatively soft year, housing starts should move up to about 1.30 million units, with 1992 checking in at approximately 1.45 million units.

The easing of fixed-rate mortgages below 10% in both 1991 and 1992 should help the housing industry, although housing has become much less sensitive to swings in market interest rates since the deregulation of deposit rates in 1982. The availability of adjustable-rate mortgages has also cushioned the impact of interest rate changes. Next year's increase in housing construction will be concentrated in single-family homes, with builders and lenders limiting the size of development projects. A reduction in rental vacancy rates should improve potential returns in multi-family housing and result in an increase in that segment by 1992.

Housing Starts Reach Trough in 1990
(Millions of units)



Profit Outlook Improves in 1991
(Percent change in economic profits from prior year)



No improvement in the profitability of most nonresidential segments is likely before 1992. The overbuilt condition of offices, shopping centers, and hotels will continue to depress the real value of nonresidential building in 1991, following a large drop in 1990. Although contingent on the strength of the economy and amount of absorption, we currently forecast a small increase in 1992.

Business spending on capital equipment had been one of the strongest parts of the economy until declining profits and general economic uncertainty prompted many firms to defer various outlays. By the second half of 1991, however, we expect business investment in new equipment to again be growing faster than the overall economy.

Exports will continue to help support economic growth in the United States, although gains will be much more moderate than in recent years. American producers have a competitive advantage in various high-technology goods, a position which has been bolstered further by the dollar's decline on foreign-exchange markets. We expect the deficit in terms of net exports of goods and services to continue to shrink in real terms over the forecast period. As a result, American output will be rising slightly faster than our total consumption.

In contrast to faster growth from the private sector in 1991-92 relative to 1990, we anticipate a slower increase in spending from the public sector. Budget pressures will constrain outlays at the federal, state, and local levels. Events in the Middle East are likely to slow the rate of decline in military outlays, but they are not expected to reverse a downward trend. After briefly stabilizing in 1990, defense spending is likely to drop by 1-2% in real terms next year and by 3% in 1992. This decline in military spending, coupled with slow growth at other levels of government, will hold total public spending to a trend of less than 1% real growth during the next two years.

Impact on Jobs and Profits

By the middle of 1990, the economic slowdown was affecting not only the job market in manufacturing and construction but also other areas ranging from retailing to business services. Labor force growth at less than 1% a year will restrain the rise in unemployment. Nevertheless, we expect the jobless rate to peak at about 6.0% in late 1990 or early 1991 before easing back to a level of 5.3% by the end of next year. In contrast, the 1981-82 recession drove the unemployment rate up to nearly 11%.

Continued employment growth in 1992 should push the jobless rate down to about 5%, a level representing essentially full employment in the United States, by the end of that year. With continued pressure on profit margins, companies will put new emphasis on improving productivity of their existing work forces during the next two years, rather than on hiring and training large numbers of new employees.

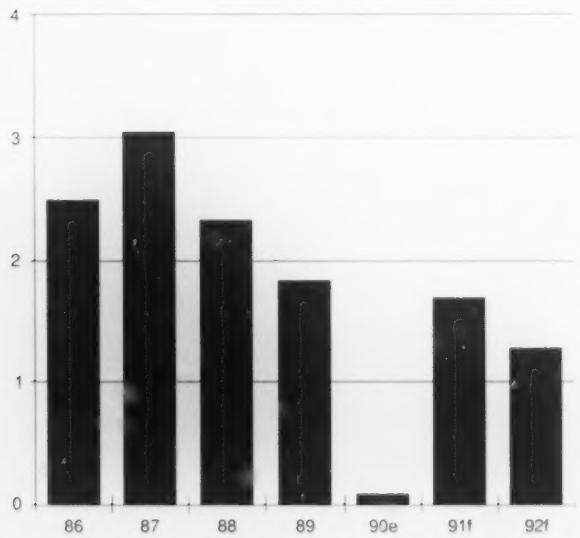
Profits appear to have borne the primary brunt of the economic slowdown until now. Economic, or "true", after-tax profits measure depreciation on a replacement-cost basis and exclude inventory profits. This measure of profits will probably show a drop of 3% when 1990 is over, following last year's 12% slide. The profitability picture should begin to recover in 1991 with better profit margins and volumes. We look for a 5% gain in economic profits for next year as a whole, followed by a 7% advance in 1992.

Inflation--Temporary Surge, Not a New Trend

Consumer prices are likely to end 1990 with a fourth-quarter-to-fourth quarter increase of 6%, the largest rise since 1981. Although a discouraging setback, the outlook for 1991 and 1992

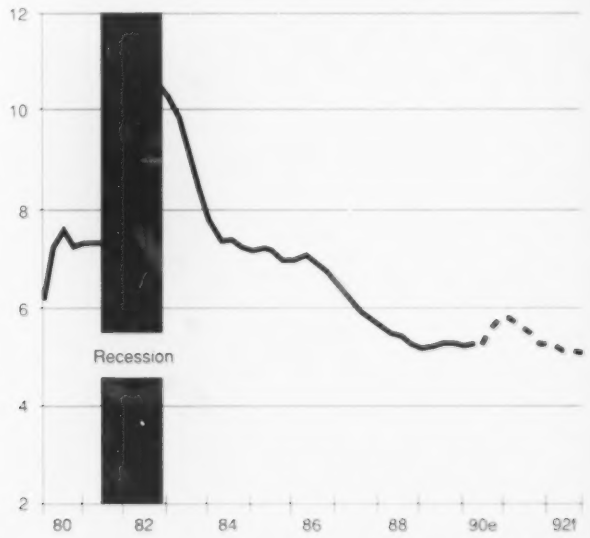
Job Growth Falters in 1990

(Millions, household series, 4th quarter to 4th quarter)



Unemployment Rate Up in Near Term

(Percent, quarterly average, all workers including military)



is much brighter.

Much of the acceleration in the 1990 price index can be attributed to the escalation of energy prices. An expected easing in energy prices in 1991 will partially offset increases in other areas and help dampen the overall rise in prices.

It is important to remember, moreover, that swings in the price of energy represent mainly a change in relative prices. Monetary policy remains the primary determinant of the general rate of inflation. As long as Federal Reserve policy remains relatively restrictive, higher energy prices will not feed through the entire wage and price structure. The tightness of monetary policy during the past three to four years strongly suggests that inflation will subside in 1991 and 1992.

Consequently, we believe that consumer prices will rise by 3.9% between the fourth quarters of 1990 and 1991. A similar 4.0% inflation rate is forecast for 1992. Largely reflecting continued upward pressure on the cost of non-wage benefits, employee costs are likely to rise by 5.0% in 1991 and 4.8% in 1992, slightly below the 5.1% advance estimated for 1990.

Interest Rates to Fall

The pace of U.S. economic growth, inflation, and events in the Middle East will dictate the course of interest rates during the next few months. We expect these factors to produce lower levels of interest rates in 1991.

While temporarily inhibited by events in the Middle East, we expect the Federal Reserve to reduce its target for the federal funds rate from the 8.0% of September 1990 to as low as 7.25% by the spring of 1991. In response to other short-term rates, the bank prime rate is also likely to ease to 9.5% by the beginning of next year, with a 9.0% prime possible next spring. A pickup in economic growth would then push short-term interest rates slightly higher by the end of next year, but greater assurance about inflation should allow short-term rates to drift lower again by the end of 1992.

Although U.S. monetary authorities can "fine tune" the level of the federal funds rate and influence other short-term rates, the long-term bond market tends to be more sensitive to market forces. The market for 30-year Treasury bonds is a mirror of U.S. inflationary expectations. The yield on 30-year bonds was moving towards 8.3% at the beginning of August 1990, but by the end of the month inflation concerns, stemming from the Middle East crisis, had driven the yield up to 9.0%.

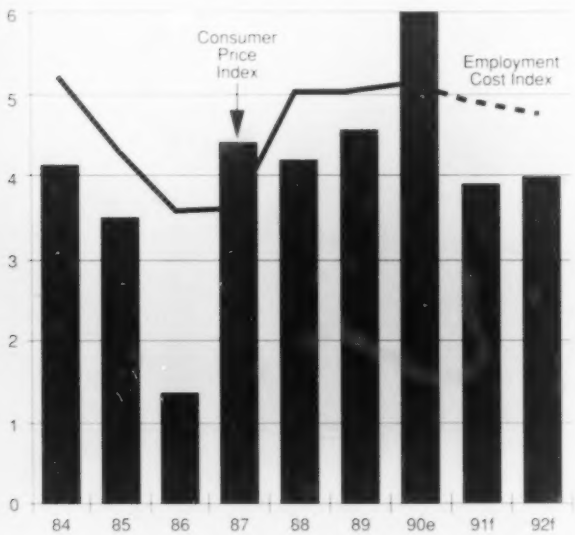
Resolution of the Middle East crisis would allow the yield on 30-year government bonds to again move back towards 8% by early next year, its level at the end of 1989. Although faster economic growth might push bond rates slightly higher by the end of next year, we believe there is a good chance that long-term government yields will edge down to slightly below 8% by the end of 1992.

Reflecting this forecast for long-term Treasury instruments, we expect 30-year fixed-mortgage rates to average 9.7% in 1991 and 9.6% in 1992. This would be down from the 10.2% average estimated for 1990.

The yield curve was very flat at the end of 1989, with long-term interest rates close to the level of short-term rates. By August 1990, the yield curve had steepened markedly. Signs of a slowing economy and an increased preference for liquidity had pushed short-term interest rates slightly lower, but the major steepening was caused by a jump in long-term rates because of inflation concerns. We expect the entire yield curve to shift downward by the middle of 1991 and to retain a more normal positive slope through the forecast period.

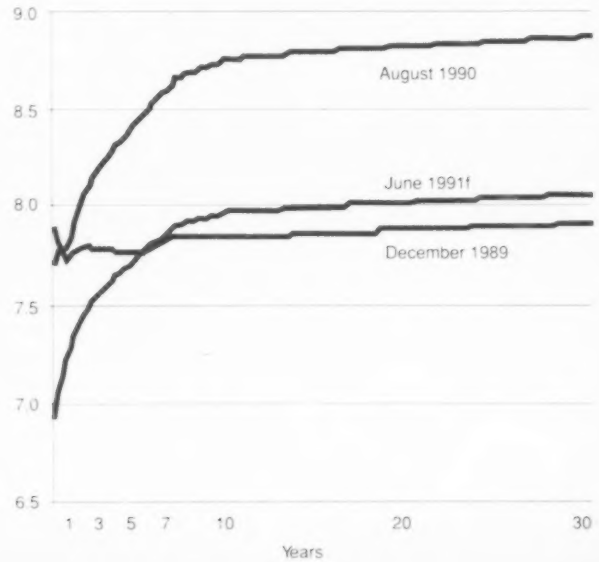
Inflation Spikes, then Eases

(Percent change, 4th quarter to 4th quarter)



Yield Curve Shifts Down in 1991

(Treasury securities, percent)



FORECAST OF INTEREST RATES

(Quarterly averages)

	1990				1991				1992			
	I	II	III	IV	I	II	III	IV	I	II	III	IV
Short-Term	Actual				Forecast							
Fed Funds (Overnight)	8.25	8.24	8.09	7.67	7.46	7.25	7.50	7.75	7.75	7.58	7.50	7.50
Treasury Bills (3-month)[1]	7.76	7.75	7.49	7.15	6.90	6.68	6.93	7.18	7.18	7.01	6.90	6.90
CDs (3-month, secondary)	8.24	8.33	8.02	7.68	7.43	7.25	7.52	7.78	7.76	7.56	7.49	7.50
Eurodollar (3-month)	8.28	8.34	7.99	7.66	7.43	7.25	7.52	7.78	7.76	7.56	7.49	7.50
Prime Rate	10.04	10.00	10.00	9.57	9.42	9.00	9.42	9.50	9.50	9.50	9.27	9.25
Long-Term												
U.S. Government Bonds (30-yr)[2]	8.44	8.65	8.74	8.33	8.00	8.03	8.07	8.10	8.13	8.07	8.00	7.90
Corporate Aaa (Moody's)	9.19	9.40	9.41	9.13	8.80	8.83	8.85	8.88	8.88	8.82	8.75	8.65
Mortgage Rate (Fixed)[3]	10.12	10.34	10.21	9.95	9.67	9.68	9.72	9.75	9.76	9.72	9.60	9.50

(1) Bank discount basis. (2) Yields adjusted to constant maturities. (3) Contract rates on first mortgages, conventional market.

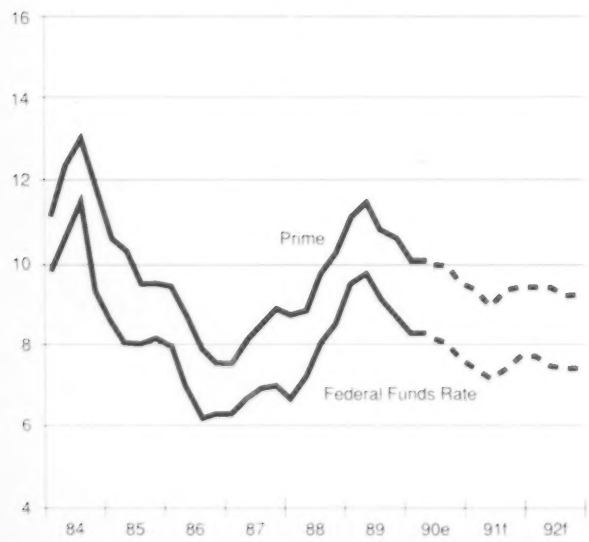
Risks to the Forecast

Our baseline forecast assumes that the Middle East crisis is resolved before 1991 without major damage to primary oil facilities. Oil prices in terms of the West Texas Intermediate benchmark would average about $20 a barrel next year. In contrast, if a stalemate in the Middle East persists well into 1991, oil prices would average about $24 a barrel next year. Growth would be about 0.5% lower than assumed under our mainline scenario, while inflation would be 0.5% higher. The Federal Reserve would be more reluctant to allow short-term interest rates to move lower in the near term, while long-term interest rates would remain high because of higher inflation and uncertainty premiums.

An all-out war in the Middle East that resulted in the destruction of strategic oil facilities, pipelines, and ports would push up inflation to 7% or higher next year and cause real GNP to plummet by as much as 3%. Both short- and long-term interest rates would move to double-digit levels until inflation and inflationary expectations could again be curbed.

Short-Term Rates Reflect Slower Economy

(Percent, quarterly average)



Long-Term Rates Stabilize at Lower Levels

(Percent, quarterly average)

U.S. industries will be operating in a cyclical economic environment for several months, involving a mild slump followed by a moderate recovery. Several factors will be especially important in the 1991 recovery: lower nominal interest rates, but still relatively high real rates; a lower foreign-exchange value of the dollar; oil prices averaging $20-$21 a barrel; and further sizable increases in the cost of employee benefits.

The strongest sectors in 1991 will be concentrated in services, although pharmaceuticals, communications, and retail food stores should also show a favorable performance. Weakness will persist in construction, several of the manufacturing industries, rail and water transportation, S&Ls, and certain segments of retailing.

Retail sales should improve, however, during the course of 1991 and in 1992. Aerospace will continue to experience a declining defense budget but strong commercial backlogs. The oil and gas industry will expand exploration and development in the United States during the coming two years. Financial conditions in the farm sector have improved. The high-tech and capital goods industries should turn upward by the end of 1991, with exports remaining a key source of strength.

Different Stages of the Cycle

The economic slowdown has affected U.S. industries in widely diverging ways. The accompanying graph shows percentage changes in payrolls for some of the leading and lagging industries from the beginning of 1989 through August 1990.

The largest job gains have been concentrated in the broad services sector, with sizable increases in health care, transportation, retail food stores, and business services. With the exception of health care, however, job growth in the other service areas has recently slowed. Mining has rebounded, with increased activity in both metal mining and in oil and gas.

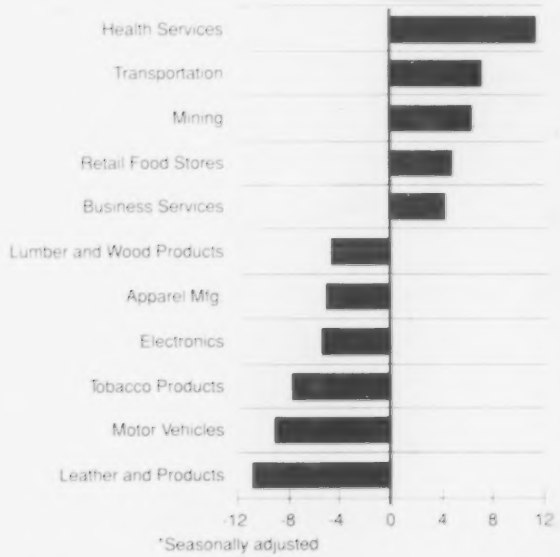
The dominant weakness in manufacturing is also evident. Since employment in the overall manufacturing sector peaked in January 1989, large job reductions have occurred in both durable and nondurable goods industries. The declines in durable goods extend from lumber and wood products to electronics and autos, while the softness in nondurables ranges from apparel and tobacco products to leather goods.

Several macroeconomic trends will have particularly important effects on industries during the next two years:

•The overall economic slump should be comparatively mild, but

U.S. Industries Diverge

(Percent change in jobs, Jan. 89 to Aug. 90*)



*Seasonally adjusted

recovery will also be moderate.

•Although interest rates will fall, real rates (adjusted for inflation) will remain fairly high, implying continued strain for highly leveraged firms.

•Exchange rates are at levels that should support U.S. exports and also bolster domestic manufacturers that compete with imports. Retailers and producers dependent on imported goods and parts will, however, be adversely affected by a weaker dollar.

•Oil prices averaging in the $20-$21 a barrel range during the next two years will support firms involved in energy exploration and development. Energy-intensive industries, ranging from chemicals and paper to trucking and airlines, will have difficulty passing on increased fuel or input costs.

•Most industries will face continued, sizable increases in total employee costs, despite some slackening in the labor market as the jobless rate rises to about 6% by early 1991. Wage and salary increases in the private sector will generally be restrained to the 4-5% range, but the combined cost of health care and other benefits is likely to rise 6-7%.

Strong and Weak Industries in 1991

The table in this section indicates the expected performance of major U.S. industries for 1991. Each industry is graded weak, moderate, or strong based on its expected profitability. Assessment of the entire year's results for some of the more cyclical industries is complicated by the projected economic upturn in the latter half of 1991.

The stronger industries are likely to continue to be concentrated in the services sector next year, although pharmaceuticals, communications, and retail food stores should also do well. Export-oriented firms should see further gains, and spending on capital goods should again outpace the overall economy by the end of 1991. The weakest segments will include construction, various manufacturing industries that will only slowly recover, rail and water transportation, S&Ls, and certain retail firms.

Retailing Pressures Continue

Consumer confidence plunged in August 1990 with growing fears about recession, soaring gasoline prices, higher interest rates, and escalating tensions in the Middle East. Retail sales for 1990 as a whole are likely to show a gain of only about 3.5%, the poorest performance since 1982.

Better growth in employment and real incomes during the second half of next year should yield a gain in retail sales of about 4.5% in 1991 and 5.5% in 1992. As the housing market begins to recover from this year's cyclical low, sales of home furnishings and appliances should start to turn upward by the latter part of 1991. Consumers resisted the large price increases for apparel implemented in early 1990, and sales would be seriously affected by any sizable price increase in 1991.

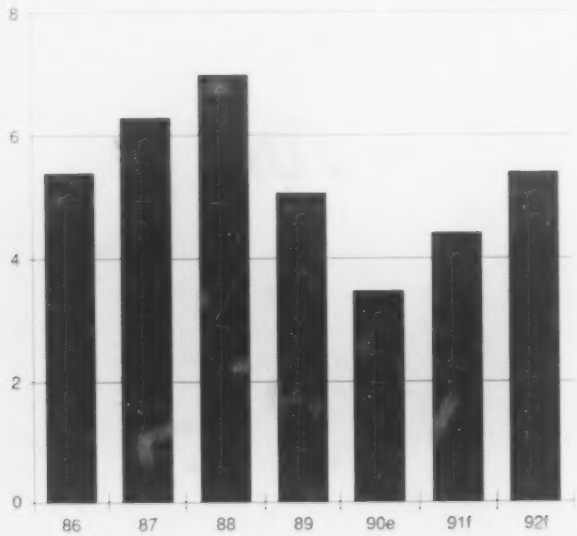
The likelihood that consumer spending will remain relatively weak in the near term will widen further the gap between strong and weak retailers. The major risk facing retailing is the possibility of a further major drop in consumer confidence and willingness to spend, as a result of rising unemployment or developments in the Middle East. From a longer-term perspective, capital spending will be increasingly vital to the retail industry to improve inventory control, monitor customer tastes, improve service, and reduce labor costs.

Recovery in Oil and Gas

Our forecast assumptions imply that 1992 would mark the fourth consecutive year with the price of West Texas Intermediate averaging in the $19-$22 per barrel range. This price should encourage annual increases of about 10% in spending for energy exploration and development in the United States

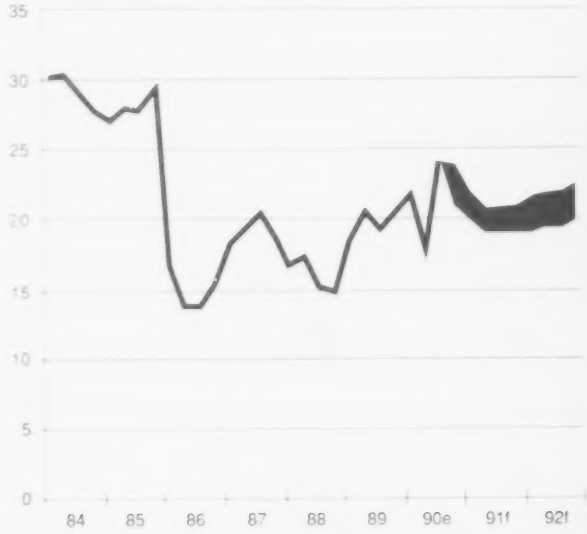
Consumer Spending to Improve

(Percent change in retail sales from prior year)



Oil Prices Average in Low 20s

(West Texas Intermediate, $ barrel, quarterly average)



INDUSTRY PERFORMANCE 1991

	Weak	Moderate	Strong
Mining and Construction			
Metal mining	•		
Coal		•	
Oil and natural gas		•	
Construction	•		
Manufacturers			
Food products		•	
Tobacco		•	
Textiles	•		
Apparel	•		
Lumber and wood products	•		
Furniture and fixtures	•		
Paper		•	
Printing and publishing		•	
Chemicals		•	
Pharmaceuticals			•
Petroleum refining		•	
Rubber and plastics	•		
Leather products	•		
Stone, clay and glass	•		
Primary metals	•		
Fabricated metals		•	
Industrial machinery		•	
Electronics		•	
Automobiles	•		
Aircraft & other trans equip		•	
Instruments		•	
Transportation and Utilities			
Railroads	•		
Local passenger transit		•	
Trucking	•		
Water transportation	•		
Air transportation		•	
Communications			•
Electric and gas utilities		•	
Trade			
Wholesale		•	
Retail--Building materials		•	
Retail--General merchandise	•		
Retail--Apparel	•		
Retail--Food stores			•
Retail--Auto related	•		
Retail--Furniture		•	
Retail--Restaurants		•	
Finance and Real Estate			
Banks		•	
Savings and loans	•		
Security, commodity brokers	•		
Insurance	•		
Real estate		•	
Services			
Hotels and lodging		•	
Amusement and recreation		•	
Advertising		•	
Motion pictures			•
Pollution control			•
Health care	—	•	
Broadcasting		•	
Legal			•
Accounting		•	
Security			•
Education			•
Employment agencies		•	

during the next two years. Energy companies may still find it less expensive to search for and develop energy sources in other countries, however.

Over the longer term, we expect the oil/natural gas price ratio to approach about 10 to 1 ($20 per barrel price for oil would imply a gas price of $2.00 per million Btus). The supply of natural gas relative to demand has kept gas prices below that implied level, but environmental demands should raise the relative price of gas over time due to its advantage as a clean fuel.

The principal risk facing the oil and gas industry would be a plunge in oil prices back to $15-$16 a barrel. Ending of the Middle East crisis without substantial damage to oil facilities, a further weakening of OPEC, and slower world economic growth could produce such a result.

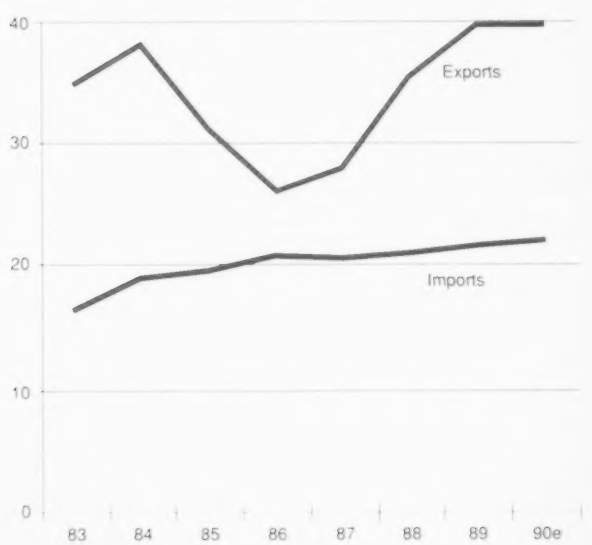
Farm Sector on the Mend

U.S. agricultural conditions have recovered significantly from the troubled state of the mid 1980s. Record wheat and corn harvests have recently pushed down grain prices, but total net farm income for 1990 is likely to match last year's strong showing of $49 billion.

After bottoming out in 1987, farmland prices appreciated 5.5% in

Agricultural Exports Continue to Outstrip Imports

(Billions of dollars)



each of the subsequent two years. Prices have probably risen about 4% this year, and we expect another 3.5-4.0% gain for 1991. Farm balance sheets also have improved, with a reduction in the debt/equity ratio from an average of about 29% in 1985 to approximately 19% in 1990.

As depicted in the accompanying graph, the value of U.S. farm exports continues at nearly twice the value of imports. Even though they are experiencing a bumper crop, the Soviets will continue to import extensively from the United States until they develop better harvesting and distribution systems. American farm exporters, however, will face intense competition in world markets, especially if crop conditions are favorable in the coming year.

Aerospace--Any Change in Trends?

The Middle East crisis immediately raised new uncertainties for the aerospace industry. Would prospects for defense firms improve, while commercial orders were canceled or cut back because of new financial pressures on the airlines?

As mentioned in the previous section, the trend toward lower real military outlays is unlikely to be reversed, but it probably will be slowed. We expect total defense spending to be about 5.1% of total GNP by fiscal 1992, compared with an estimated 5.5% in fiscal 1990 and the recent peak of 6.5% in fiscal 1986. Prime contract awards have already dropped from a peak of $154 billion in fiscal 1985 to $132 billion in 1989 and could fall to about $120 billion by fiscal 1992. However, the Middle-East situation has placed a new emphasis on a technically advanced, flexible, and mobile defense capability. Foreign demand for American military products will also now be stronger.

Because labor and fuel constitute major costs of the airlines, the sharp run-up in oil costs after Iraq's invasion of Kuwait was a serious blow to their profit positions. A moderation in oil prices from the 1990 highs will improve the financial condition of air carriers, although the market may still not be strong enough to allow remaining fuel-cost increases to be fully passed on to customers.

Nevertheless, the commercial aircraft industry should remain strong because of large backlogs. Worldwide, firm orders for aircraft currently number over 3,000. The pace of new orders is likely to moderate, but some of the airlines with stronger balance sheets may opt to update their fleets with more fuel-efficient planes.

High Tech Dips, then Recovers

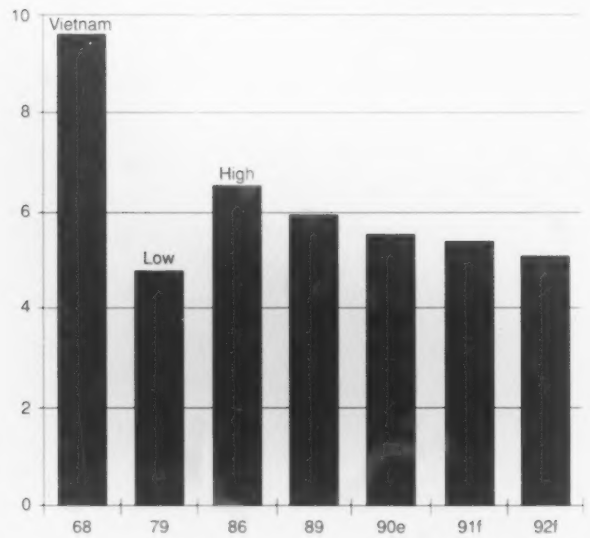
The high-technology industry will experience weak domestic demand until about the middle of next year, when auto sales and business capital spending are expected to improve. The near-term slowing of the economy will affect certain segments of the industry more than others. The semiconductor market will remain essentially flat until well into 1991, and foreign competition will continue to erode the market share of U.S. producers. Long-term prospects are more favorable as technological advances encourage greater use of chips in a whole host of products, ranging from automobiles to telecommunications equipment.

Computers and peripherals will show limited growth until the second half of next year, as sales of PCs continue to moderate. Many companies are absorbing their purchases and waiting to see which operating system will prevail.

The software segment of the high-technology industry should continue to experience considerable growth. Consumers are now demanding software that is compatible among PCs, minis, and mainframes, while corporations make greater use of local area networks. Telecommunication sales will be a strong high-tech segment, as deregulation has opened up the U.S. market and opportunities are abundant in foreign markets.

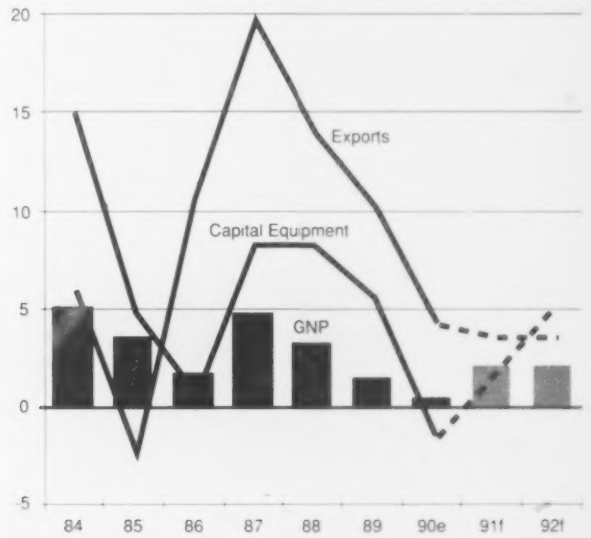
Defense Spending Trends Down

(Percent of GNP fiscal year)



Exports and Capital Equipment Growth Leaders

(Real percent change, 4th quarter to 4th quarter)



Financial Institutions

The monumental cost of bailing out the thrift industry, the sharp rise of nonperforming loans in bank portfolios, the continuing high incidence of bank failures, and the plunge in market capitalization of many of the largest banks have focused attention on the urgency of bank reform. By most measures of profitability, the U.S. banking industry in 1990 is having its worst year since heavy losses on Third World loans devastated operating results in 1987. A prolonged stalemate in the Middle East could worsen the outlook for bank performance in the second half of 1990 and in 1991. Such an outcome could contribute to a stagnant economy, higher inflation, and unsettled financial markets.

The ability of the RTC to speed up its disposition of insolvent S&Ls and foreclosed property will depend on the condition of real estate markets in 1991-92, as well as the strength of the banking industry. Unless "FIRREA II" contains some dramatic elements to accelerate the bailout, it is very likely that the process will continue through 1995.

The FIRREA-mandated Treasury study of the deposit insurance system, to be published in December 1990, will set the stage for framing legislation in 1991.

More caution in the providing and assuming of new credit is likely to characterize the credit markets in the early 1990s.

Bank Reform--A New Urgency

Any further deterioration of real estate markets in 1991 could accentuate the already tough posture of regulators, anxious to identify weak banks at an early stage. There is only a slim probability, however, that Congress will enact urgently needed legislation in 1991 to modernize the American banking system. Instead, the centerpiece of any major financial reform legislation in 1991 is likely to be deposit insurance--as part of a "FIRREA II" revisit of the savings and loan industry bailout. Momentum could build by 1992 for broad-based financial reform legislation, especially as European financial market unification will by then be close at hand and the Basel Accord capital standards must be met.

Considerable uncertainty will persist about the soundness and competitiveness of American banks until Congress faces up to the need for reform and institutes new policies. Impetus for new policies will come from the growing realization that the international competitiveness of U.S. financial institutions has been seriously weakened at a time when the globalization process is accelerating. Reform in 1992 or later may include the following: a) expanding the powers of banks to allow them to underwrite

and sell securities and insurance products, either along the lines of the German model of universal banking or through a "financial services holding company;" b) removing restrictions to geographic expansion, in order to permit wider market access and diversification of risk; c) easing the regulatory burden imposed by the high cost of reserve requirements, deposit insurance, compliance regulations, and multiple regulatory oversight; and d) realigning capital-adequacy rules that would help banks to maximize price/earnings ratios while adhering to accepted principles of risk-taking.

Capital Standards Still Troublesome

Effective September 1990, bank holding companies and state banks that are members of the Federal Reserve must meet a minimum standard of equity capital equal to 3% of assets. This new capital ratio of 3% must be met simultaneously with the transition to Basel standards of 7.25% total capital to assets by end-1990 and 8.00% by end-1992. No such dual standard exists in the other countries that signed the Basel Accord. Some banks will choose to shrink their assets to meet the new capital rule.

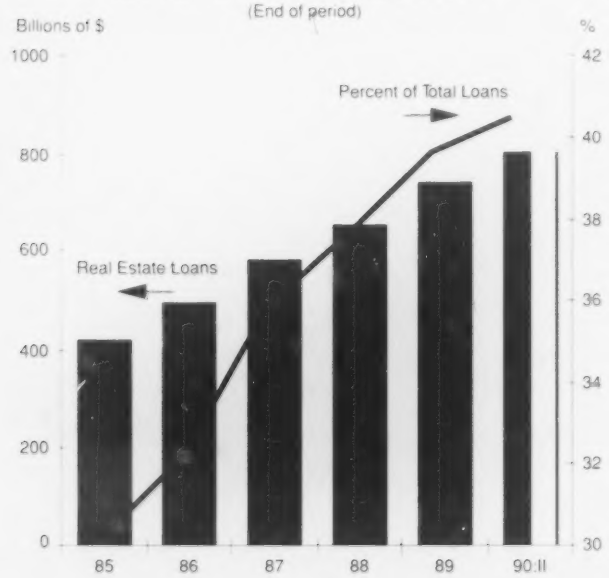
An extra burden imposed by the 3% capital ratio is that it is tied to "CAMEL" ratings by regulators--a scale of 1 to 5 that measures a bank's capital, assets, management, earnings, and liquidity. If a bank is not given the top rating of "1," it must maintain a capital ratio at least 100 basis points and as much as 200 basis points above the 3% minimum. Given the equity market's recent distaste for bank stock issues, this could be extremely costly for the banking industry. Moreover, the subjective nature of CAMEL ratings introduces a considerable degree of arbitrariness as to whether or not a bank has sufficient capital.

Real Estate Loans Pose Big Challenge

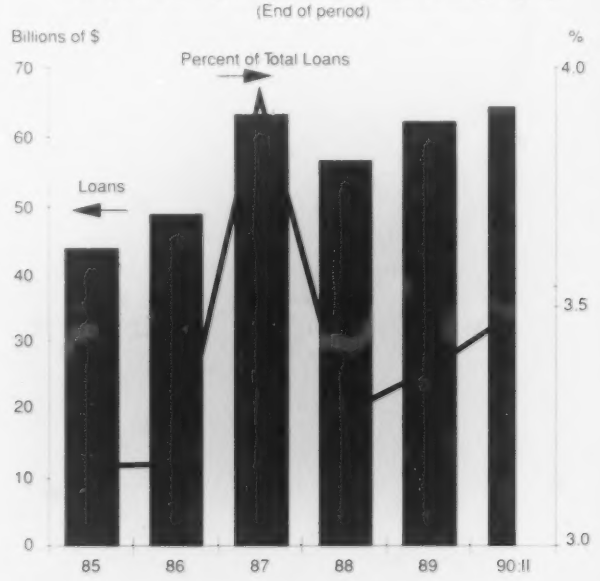
The sharp increase in real estate lending by banks in the second half of the 1980s has made this category of loans the largest in the banking industry's portfolio. Total real estate loans outstanding increased 89% from the end of 1985 to mid 1990 to $803 billion--moving up from 30% of total loans to 41%. This growth has resulted from the loss of market share by the ailing thrift industry (especially since 1988), the relatively slower growth of business loans (as securitization has advanced and as large corporations continue to bypass banks), and the long-running construction boom since the mid 1980s. For many super-regional banks, and to some extent money-center banks, monitoring and controlling real estate loan growth will be an increasing challenge in 1991-92. A contraction of the economy, high mortgage interest rates, and RTC (Resolution Trust Corporation) "dumping" of foreclosed real estate would be devastating for credit quality in some real estate portfolios.

Nonperforming loans in the banking industry increased nearly 50% from the end of 1985 through the first quarter of 1990 to $64.4 billion. After having peaked in 1987 at 3.94%, the ratio of nonperforming loans to total domestic loans declined to 3.28% in 1988, but it has moved back up to 3.48% in early 1990. Contributing to this worrisome trend are loans to finance highly leveraged transactions. The key factor in the rise in this ratio, however, is deteriorating real estate loan quality. The response of regulators to these developments--more frequent and tougher examinations--is likely to continue in force through much of 1991. Banks are also likely to maintain or tighten further their lending policies in order to minimize any further rise in nonperforming loan ratios. At mid 1990, nonperforming loans at the ten largest banks in the nation ranged from 1.9% to 10.4% of total loans. The highest ratios are

Real Estate Loans at Banks Escalate



Nonperforming Loans at U.S. Banks Edging Up



concentrated in banks in the Southwest and New England.

S&L Bailout Proves Overwhelming

The Bush Administration, particularly the RTC, has come under severe criticism for its handling of the S&L crisis. The general attitude of critics is that the bailout is costing too much and moving too slowly. The bailout actually started before the RTC was created in August 1989 and resulted in the sale by the Federal Home Loan Bank Board of over 200 failed thrifts in 1988, at a cost to taxpayers of $4.6 billion in the first year. Thrift costs probably added more than $60 billion to the federal deficit in fiscal 1990. In its first year of operation, the RTC sold or closed 211 institutions and it is now estimated that at least another 600 S&Ls could be taken into conservatorship. As of the middle of 1990, 1,175 thrifts (representing 35% of the industry's assets) were identified as well-capitalized and profitable. Another 680 thrifts were marginally profitable and had adequate capital. On the "sick list" were almost 600 institutions deemed either unprofitable and poorly capitalized or candidates for RTC takeover. In the first six months of 1990, 52 insolvent thrifts were seized by the RTC.

To date, banks have been the most aggressive buyers of S&Ls, having acquired two thirds of all institutions sold by the RTC. The downside of the S&L crisis has been its enormous cost, its negative impact on the federal budget, and the reduced level of confidence in U.S. financial institutions. The upside for banks has included the opportunity to expand market presence at relatively low cost. Healthy thrifts have also been active buyers of sick thrifts, acquiring over one fifth of resolved institutions.

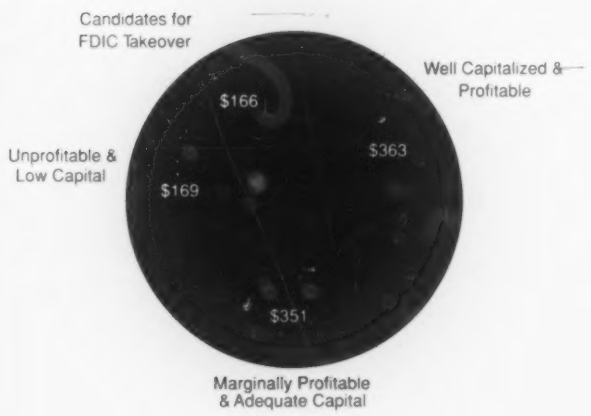
Deposit Insurance Reform Now Urgent

The proposed increase of bank deposit insurance premiums from 12.0 cents to 19.5 cents per $100 of deposits effective in 1991--a 63% increase--has raised the urgency of reforming the flawed system of flat premiums (with a 100% government guarantee). Because of the sharp climb in bank failures during the past five years--including a few big banks--FDIC coverage has fallen sharply, from $1.10 to $0.55 per $100 of deposits. There is some chance that premiums could be raised, subject to congressional approval, to an even higher level in 1991 that would almost double the 1990 rates. The FDIC recorded declines in its funds for the first time in 1988--$5 billion in 1988 and 1989 combined--and expects to suffer another loss of $2 billion in 1990. Adding to the urgency of reform is the overwhelming consensus that the "moral hazard" aspect of the existing insurance system encourages ill-conceived risk-taking by financial institutions and fosters the practice of "forebearance"--allowing insolvent institutions to remain open rather than identifying and treating them at an early stage.

One of the key elements of the Treasury report on deposit insurance could be a lowering of the $100,000 coverage, coupled with restricting coverage to one account per individual. Much controversy is expected, however, on proposals by either the Treasury or others to a) take the federal government out of the insurance business entirely, b) exclude brokered deposits from coverage, and c) introduce risk-based premiums. Fundamental to the debate on deposit insurance will be the search for the most effective system that would both assure the soundness of the banking system and bolster the competitive strength of financial institutions so they can contribute to an expanding economy.

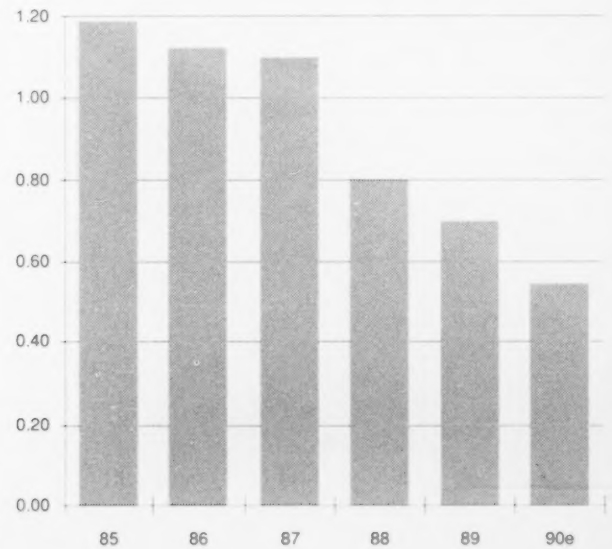
No Early End to S&L Bailout

(Assets in billions, June 1990)



Bank Deposit Insurance Coverage Dropping

(Per $100 of insured deposits, year-end)



Business Financing Patterns to Shift

During the current economic expansion, corporations have dramatically increased their debt. In 1989, outstanding credit market debt of nonfinancial corporations reached $2.1 trillion, doubling since 1983. The share of business assets financed by debt during the 1980s exceeded that of any other period since World War II. A significant portion of this debt was devoted to retiring equity. On a net basis, over $650 billion in equity has been retired since 1983. In 1989 alone, net new issues of stock declined by over $130 billion. In addition to the repurchasing of stock shares, the trend toward mergers and acquisitions, restructurings, expansions, leveraged buyouts, and recapitalizations has contributed to substantial increases in debt. We expect retirement of equity to decelerate significantly as the merger-and-acquisition drive subsides.

The fastest growing major component of debt has been commercial paper, with a gain of more than 35% expected for 1990. Bank loans have been recording very weak growth since 1987 and are actually expected to decline slightly during 1990. Corporate bonds, the largest component of corporate debt with nearly half the total, are expected to grow about 10%. Since 1986, growth of both bonds and bank loans has been trending lower, while the commercial paper market has soared. With lower interest rates, firms are likely to attempt to move toward longer-term debt to lock in the lower rates.

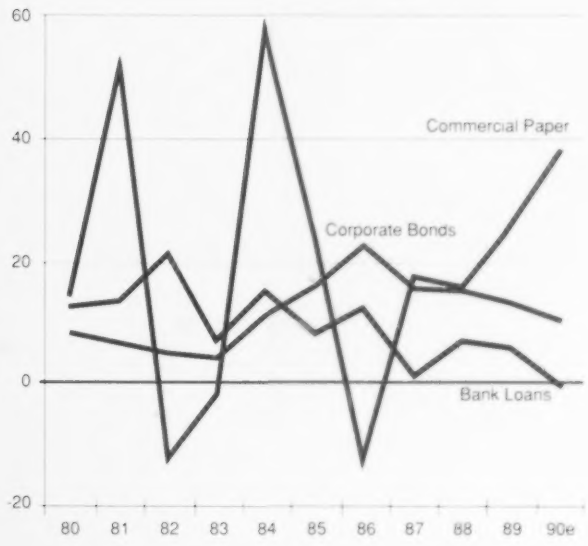
The tax law has encouraged firms to rely more on debt financing by imposing a lower tax burden on assets financed by debt than by equity. Tax laws alone, however, do not determine a corporation's capital structure. Relative cost of funds, the existence of expansion opportunities, various regulations and accounting conventions, shareholders' incentives, and management's strategic plan all play vital roles. We expect that over the next two years companies will reduce their debt as a percent of equity. Leverage is likely to be reduced as the economy slows and the expected cost of financial stress starts to outweigh the benefit of the tax shield for debt. There is also risk that high levels of corporate debt have increased the probability of firms going bankrupt. Other theories, however, suggest that the additional leverage actually provides an incentive for management to become more efficient and spurs them to work toward more cost savings and the streamlining of operations. Such views would argue that the increased debt levels impose a valuable discipline on industries and the economy.

Corporate profits and cash flow declined significantly in 1989, and we expect further weakness before a pickup begins during 1991-92. Typically, lower profits have caused a slowdown in the growth of fixed investment by corporations because of the reliance on internal funds for financing. Evidence indicates, however, that this historical relationship between profits and investment diverged during the 1980s mainly because of the additional use of debt financing. Thus, the level of business investment is not limited as much by corporate profits or cash flow as it once was, although financing constraints still are important in determining total investment. The expected reduction in long-term rates in 1991-92 should reduce the "hurdle rates" of various investment projects.

Creditors are being more cautious and selective about the quality of their borrowers. Equity will return as a more important financing source. A shift from debt to equity would reflect more conservative financial management by corporations that are concerned about the increased risk of bankruptcy and vulnerability in a slower economy.

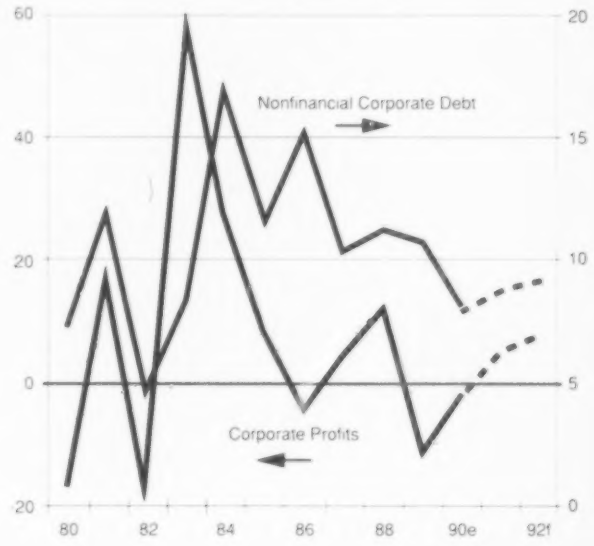
Firms Turn to Commercial Paper Market

(Nonfinancial companies, percent change from prior year)



Corporate Debt and Profits Move Together to Finance Expansion

(Percent change from prior year)



The International Economy

Industrial-country economies outside the United States show a mixed pattern, but in general growth will be maintained at rates higher than those in this country during the next two years. This, together with a continuing drop in the value of the dollar through the first half of 1991, should provide some support for U.S. export industries. In addition, real economic growth in the industrial countries will mean continued increases in the volume of world trade, although at a slower rate than during the past several years.

The financial position of some non-oil developing countries is being squeezed by the combination of the slowdown in the rate of growth in world trade, higher international interest rates, and higher oil prices. Nevertheless, progress in policy reform is improving the overall performance of some countries.

During 1990 and 1991, further declines in the U.S. trade and current-account deficits are forecast. Nevertheless, the current-account deficit will still be a substantial $95 billion in 1992.

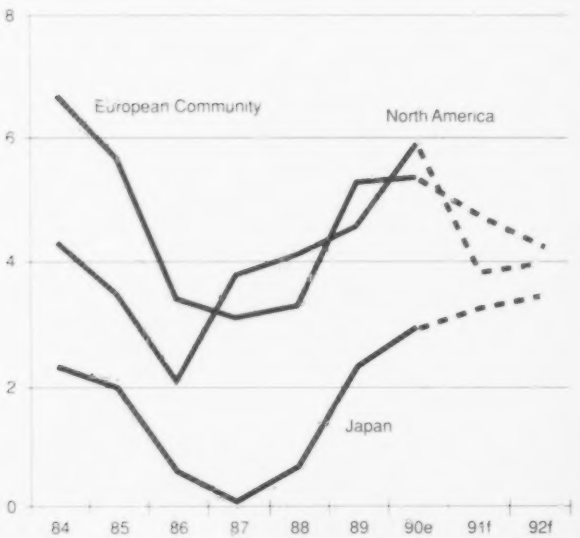
Inflation Up, Growth Down in Industrial Countries--But Not Much

Real economic growth in the major industrial countries outside the United States is generally slowing only slightly, in contrast with the situation in North America. In continental Europe, the impetus from the 1992 market unification, from the reunification of Germany, and from increased trade and investment opportunities in Eastern Europe are all continuing the growth momentum that has developed over the past three years. In Japan, despite the drop in equity prices that has occurred during the past ten months, growth is expected to be maintained at around a 4% annual rate during 1991 and 1992, following 1990's estimated rise of 4.9%. Further gains--although at slower rates than in recent years--in fixed investment and consumer spending within Japan are the most important sources of the continued strength.

The major threat to the maintenance of this relatively good growth performance is the possibility of higher inflation. While consumer prices in Japan and Germany are still rising at relatively modest rates (estimated at about 3% in both countries for 1990), the rates of increase of the monetary aggregates have caused concern to the central banks of both countries. In

Inflation Rates Converge by 1992

(Percent change in consumer prices from prior year)



	Real Economic Growth (GDP, annual average % change)				Inflation (CPI, annual average % change)				Current-Account Balance (Billions of dollars)			
	1989	1990e	1991f	1992f	1989	1990e	1991f	1992f	1989	1990e	1991f	1992f
Japan*	4.8	4.9	3.8	4.3	2.3	3.0	3.3	3.5	56.8	38.8	29.1	31.3
Germany*	4.0	3.8	3.6	4.0	2.8	2.8	3.6	3.5	55.6	58.8	44.6	39.0
France	3.7	2.9	2.6	3.0	3.5	3.2	3.6	3.2	-4.3	-3.2	-1.5	-3.0
Italy	3.2	2.6	2.4	3.2	6.3	6.1	5.4	4.7	-11.8	-12.5	-10.3	-8.0
United Kingdom	2.2	0.8	1.2	2.2	7.8	8.8	4.9	4.0	-31.2	-28.5	-23.0	-19.0
Canada	3.0	0.9	1.6	2.8	5.0	4.8	4.4	3.1	-16.6	-14.0	-12.0	-9.0
Total of above countries	3.9	3.4	3.0	3.6	3.8	4.1	3.9	3.7	48.6	39.4	26.1	33.3
G-7 (Above + U.S.*)	3.3	2.5	2.3	3.2	4.2	4.7	4.2	3.8	-61.5	-86.4	-74.2	-61.6

*GNP used for real growth

addition, rising oil prices during the second half of 1990 have added to inflationary fears. Higher inflation expectations are probably a major reason for higher long-term interest rates in European and Japanese markets.

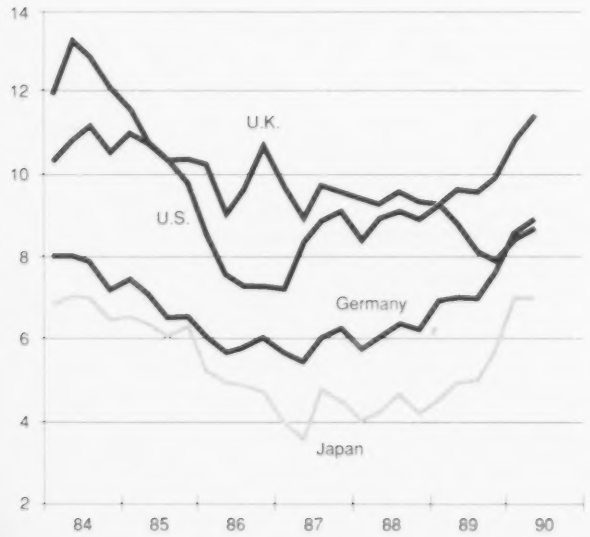
It is our expectation that inflation will not rise greatly in either Germany or Japan, with consumer prices rising perhaps 4% in Germany and in the 3-4% range in Japan during both 1991 and 1992. The central banks of both countries have raised interest rates during the course of 1990 in order to stem rises in the monetary aggregates and consumer prices. In addition, the Japanese yen, weak for some time, has recently strengthened considerably, while the deutschemark reached record highs against the dollar by September 1990. The strength of these currencies will help limit price rises.

In Europe, the monetary discipline provided by the exchange-rate mechanism of the European Monetary System is bringing about a convergence of inflation rates to the German rate. By 1992, inflation in most countries will be close to German levels, paving the way for eventual monetary unification. The United Kingdom, which has remained outside this mechanism, is likely to join soon. As will be seen in the accompanying table, it is expected that inflation in the six largest industrial countries outside the United States will average slightly below the U.S. rate during the coming two years.

How vulnerable are these developments to an oil price shock? Our expectation is that the price of oil will average about $1 a barrel lower in 1991 than in 1990. However, should it average much higher, the industrial economies still would not fall into recession. The impact of higher oil prices would vary across countries. As indicated in the accompanying graph, the three largest industrial economies outside the United States (Japan, Germany, and France) are relatively less oil-intensive. The ratios for all countries are considerably lower than they were during the mid 1970s, when a global recession followed (much larger) oil price rises. Thus, while some slowing would probably result, a global recession appears unlikely. In particular, German and Japanese growth would be likely to remain well

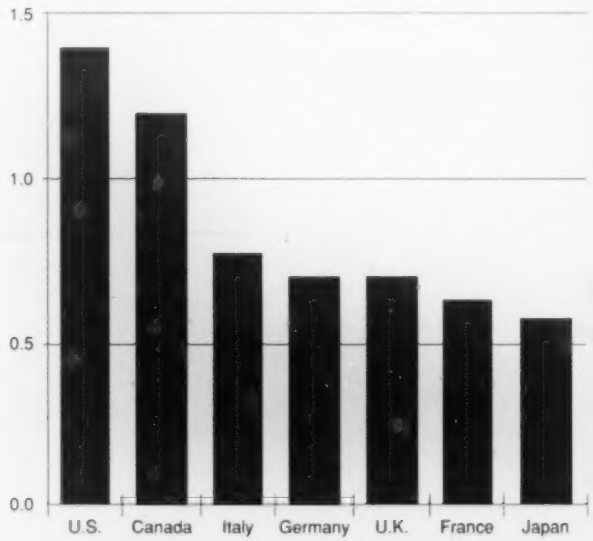
Long-Term Interest Rates Have Risen

(Government bond yield, percent, quarterly average)



Japan, Europe Less Vulnerable to Oil Price Rise

($10 increase in cost of oil consumption as percent of GNP)



on the positive side, providing some momentum to the trading partners of the two countries.

The prospect of monetary unification, combined with the virtually complete elimination of trade barriers for both goods and services, is a powerful impetus to investment in Europe. During 1989, private fixed-capital formation rose very strongly, reflecting the imminence of a greatly enlarged market and lower operating costs resulting from the reduction of barriers. This trend appears to have been sustained during 1990, although slowing in some countries--notably the United Kingdom and Spain--has been evident. During 1991 and 1992, the beginning of a trend toward increasing trade with Eastern Europe will maintain the investment momentum.

German unification, which occurred October 3, has created by far the largest economy in Europe. The macroeconomic effects of unification are likely to include: (1) a longer period of somewhat higher inflation than would have occurred otherwise; (2) a substantial increase in the budget deficit; (3) a very high level of investment in modernizing and cleaning up East German industry, as well as in housing; and (4) a continued, high rate of economic growth. Illustrating the magnitude of the problem of integrating the two dissimilar economies is the differential in labor productivity. It is estimated that output per worker in the former East Germany is only about 40% of the level found in western Germany. This implies that in order to reach western levels within 15 years, productivity in the eastern part of the country would have to grow 8.5% annually, a very difficult rate to achieve. The investment necessary to bring about a rapid increase in productivity will be substantial. Part of it will come from the DM115 billion (about $73 billion) "Unity Fund," the majority of which will be financed by bond issues. This and private investment demand are expected to keep real German interest rates relatively high for some time.

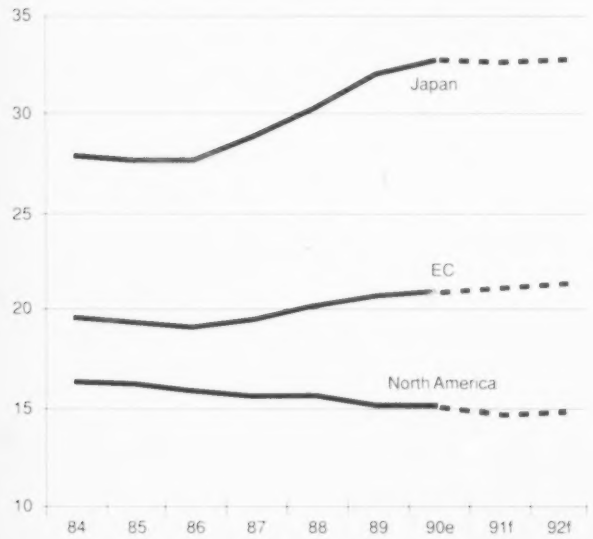
The very large surpluses in the Japanese current-account balance of payments have come down substantially. From a peak of $87 billion in 1987, the surplus is estimated to have fallen to $39 billion in 1990, and we expect lower levels of about $30 billion annually in 1991 and 1992. This implies that the rate of increase in Japanese assets overseas will be considerably slower in the coming two years. In 1990, West Germany's current-account surplus, at an estimated $59 billion, is substantially larger than the Japanese surplus. German investment throughout Europe has been quite strong in the past two years. The German surplus is likely to fall during the next two years, with corresponding decreases in the deficits of other Western European nations. The investment necessary to revive the economy of eastern Germany will absorb more of German savings, and the current-account surplus of united Germany will be an estimated $9 billion lower than that of West Germany alone would have been. In addition, investment in Eastern Europe may reduce somewhat the proportion of German investment in other European markets.

East Meets West: Reform in Eastern Europe

The countries of Eastern Europe are undergoing an important process of economic reform. Although the pace and path of reform differ in each country, the goal of a market economy with an important role for the private sector is general. The countries that appear to be reaching this goal the fastest are Poland and Hungary, with Czechoslovakia likely to make rapid progress in 1991. Financially, Czechoslovakia is in the best position to undertake the cost of economic transformation, while Poland, Hungary, and Bulgaria have problematic

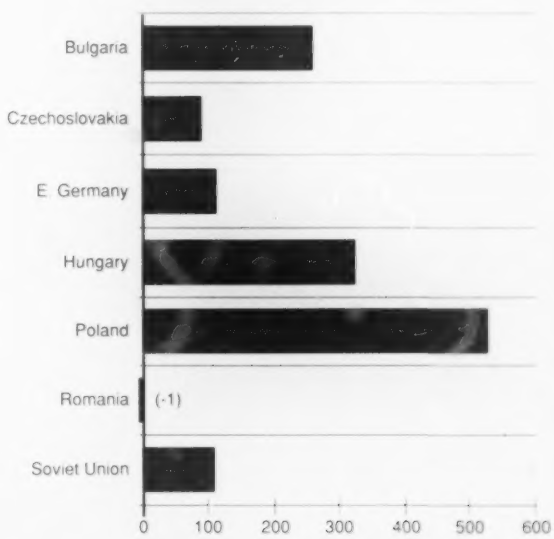
Investment Rising Outside North America

(Gross fixed-capital formation as percent of GNP)



High Debt Levels in Some E. European Countries

(Ratio of net debt to exports, percent, 1989)



external financial positions. Nevertheless, substantial assistance from international organizations and foreign governments will be available. Already, approximately $6 billion annually in 1990 and 1991 will come from the IMF, the World Bank, and governments, mainly for Poland and Hungary. The European Bank for Reconstruction and Development will provide additional resources.

The economy of the USSR, which is undergoing severe difficulties, may be broken into a number of different economies during the forecast period, even if political association among the various republics is somehow maintained. Unlike the smaller countries in Eastern Europe, it is unlikely that the USSR as a whole can be the recipient of foreign financing to any major degree. It must rely primarily on domestic resources to undertake the economic transformation. This makes the task even more daunting.

It is clear that the reform of the Eastern European economies and those of the Soviet Union will create new markets for Western companies. Foreign direct investment by Western European, American, and other companies is already increasing, notably in Hungary but elsewhere as well. Trade relations between North America and the countries of this region are still relatively undeveloped, and financial constraints and competition from Western Europe and East Asia make it improbable that there will be an immediate boom in trade. In particular industries, however, such as agricultural technology, computers, and pollution control, American companies may find opportunities.

World Trade To Record Ninth Year of Expansion in 1992

Unless the situation in the Middle East worsens substantially without a resolution or becomes a long, drawn out affair, either of which would seriously detract from industrial-country economic prospects, we look for world trade measured by imports to record its ninth year of expansion in 1992. As can be seen from the data in the table, world trade last contracted (because of a decline in import prices) in 1983, following the worldwide recession of 1982.

Industrial countries produce approximately 72% of the world's exports (excluding most of the trade of the former Eastern bloc) and purchase a similar percentage of the world's imports. The developing world produces about one fifth of the world's economic output, and it supplies approximately 28% of world exports. Industrial countries purchase approximately 60% of developing-country exports.

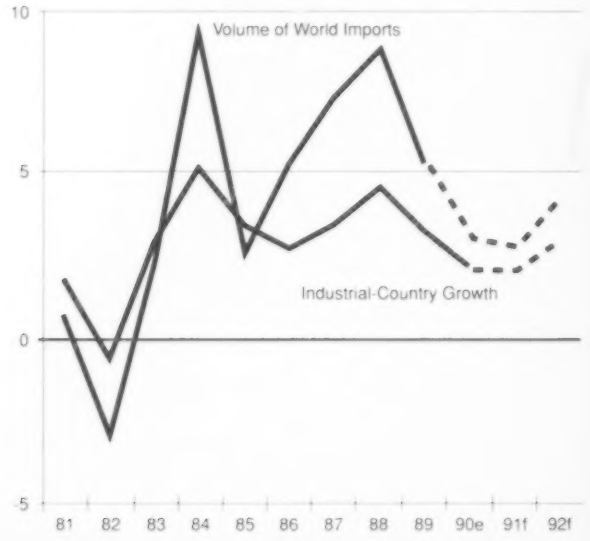
World trade is an important mechanism by which more vigorous economic growth in different parts of the world is transmitted to other parts of the world economy. The transmission is clearly more complete where receptivity is greater, that is, where a market economic system allows the economy to adjust to altered economic conditions.

WORLD TRADE
(Imports, percent change)

	Volume	Prices	Nominal
1982	-3.0	-3.7	-6.6
1983	2.1	-5.0	-3.0
1984	9.4	-2.6	6.5
1985	2.5	-1.7	0.8
1986	5.3	3.6	9.3
1987	7.3	9.8	17.8
1988	8.7	4.8	13.9
1989e	5.3	2.5	8.0
1990f	3.1	2.6	5.8
1991f	2.8	2.4	5.3
1992f	4.3	4.9	9.4

Although trade patterns generally change relatively slowly, they can show substantial differences over a period of several years. For example, during the 11-year period 1978-88, the share of exports produced by the

Volume of World Imports Reflects Real Economic Growth in Industrial Countries
(Percent change from prior year)



developing world remained amazingly constant--about 27.5%. Among the regions in the so-called Third World, the clear success has been Asia. It accounted for 8.1% of world exports in 1978 and 13.5% in 1988. Except for developing Europe, all other regions saw their share of world exports diminish: the Middle East fell from 9.5% to 3.7% as energy prices plummeted; Africa from 3.9% to 2.7% as it continued to distance itself from a market system; and Latin America, from 4.9% to 4.3% as it reeled from the effects of poor economic policies and debt problems. Even the disintegrated Eastern bloc's trade with the outside declined as its share of world exports fell from 3.0% in 1978 to 2.2% in 1988. Although this decreased share reflects an emphasis on intra-bloc trade, the emphasis resulted in large part from an inability to produce goods that were competitive on world markets.

We estimate that growth in world trade volume, *i.e.*, adjusted for inflation, will slow during 1990-91, reflecting the industrial-country slowdown during both years. We look for industrial-country real economic growth to decline to approximately 2.2% in 1990 from 3.2% in 1989. After the slower growth in 1990-91, we expect the volume of world trade to increase at a faster rate in 1992 as industrial-country economic expansion rises.

Import prices should generally rise at approximately the same rate during 1989-91, before they increase more rapidly in 1992. The composition of the price increases in each year is substantially different, however. Forecasting energy prices clearly carries the greatest risk. Our assumption that the crisis in the Middle East will not be protracted results in a forecast of average oil prices rising nearly 10% during 1990 from 1989 levels and then falling about 6% in 1991. We believe that non-energy commodity prices will decline approximately 7.5% on average in 1990 from the year-earlier average. The International Monetary Fund's "world" commodity price index, which excludes energy prices, fell 12.7% during the first half of 1990 from the year-earlier level. As the accompanying chart shows, prices for beverages fell the most during the first half of 1990 and agricultural raw materials the least. We look for only a modest increase in non-energy commodity prices in 1991. After industrial-country inflation peaks in 1990, it trends downward through 1992, which implies that price rises for products with a greater degree of processing should moderate during 1991-92.

Difficult Conditions for Developing Countries

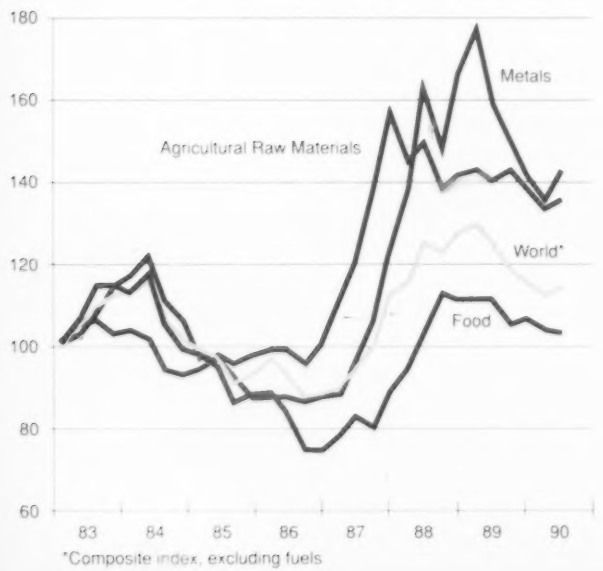
The combination of higher international interest rates, higher oil prices, and slower industrial-country growth is not favorable for those developing countries that do not export oil. Heavily indebted countries such as Brazil and the Philippines are seeing a worsening of the external environment that could affect their growth prospects and their external financial positions. The Philippines, in particular, is also affected by a sudden loss of revenues from its large labor force in parts of the Middle East.

For those countries that export oil, such as Mexico and Venezuela, higher oil export revenues will be a short-run boon, but a slower U.S. economy and higher interest rates will offset some of the gain. In the end, of course, it is the quality of the economic policies that will determine the economic performance and financial positions of these countries. In that regard, economic reform in Latin America provides the prospect of considerably improved performance in the coming few years.

Mexico has succeeded in renegotiating its external debt under favorable terms, and the debt constraint is now much less binding on the country's ability to grow. Although the total debt was reduced less than originally

Commodity Prices Trending Downward Since Early 1989

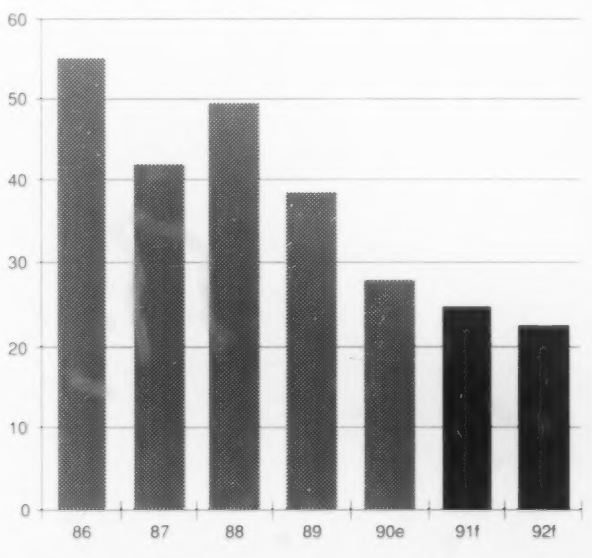
(Index, 1983=100, quarterly average)



*Composite index, excluding fuels

Mexican Debt Burden Reduced

(Interest plus amortization as percent of exports)



hoped, the Mexican government estimates that external debt at the end of 1990 will be down to $93.6 billion, compared with a peak level of $106.9 billion in 1987. The ratio of total debt to exports has been reduced from 420% in 1986 to less than 250%. In addition, the country's debt-servicing requirements over the next several years were reduced in the recent renegotiation by about $4 billion, or 11% of export revenues.

Mexico's economic prospects have been greatly boosted recently by two major policy changes other than the renegotiation of the external debt and the reduction of inflation that has been achieved. These include (1) the privatization of several large government enterprises and the announcement of the privatization of the country's commercial banks and its national telephone company and (2) the announced intention of the government to negotiate a free-trade agreement with the United States. The latter, if approved by the U.S. Congress, could greatly stimulate private investment, both Mexican and foreign, in export industries. Already, Mexican non-oil exports have risen rapidly during the past several years, and a free-trade agreement would stimulate further growth. A North American Free Trade Agreement including Canada, while not as comprehensive in scope as the Single European Market, would nevertheless create the world's largest free-trade area, exceeding by a considerable margin the European Community (EC) in terms of economic size. North America's combined population of 359 million also exceeds that of the EC by roughly 17 million people.

U.S. CURRENT ACCOUNT
(Billions of U.S. dollars)

	1987	1988	1989	1990e	1991f	1992f
Trade balance	-159.5	-127.0	-114.9	-103.7	-97.4	-92.4
Exports	250.3	320.3	360.5	386.6	411.3	444.2
Imports	-409.8	-447.3	-475.3	-490.3	-508.7	-536.6
Service balance	11.8	13.1	19.6	16.2	14.8	13.8
Service exports	181.9	213.1	242.7	250.9	263.0	279.8
Service imports	-170.1	-200.0	-223.2	-234.7	-248.1	-266.0
Transfers balance	-14.6	-15.0	-14.7	-18.3	-17.8	-16.4
Official	-10.3	-10.7	-11.0	-14.3	-13.8	-12.1
Private	-4.3	-4.3	-3.8	-4.0	-4.2	-4.3
Current-account balance	-162.3	-128.9	-110.0	-105.8	-100.1	-94.9

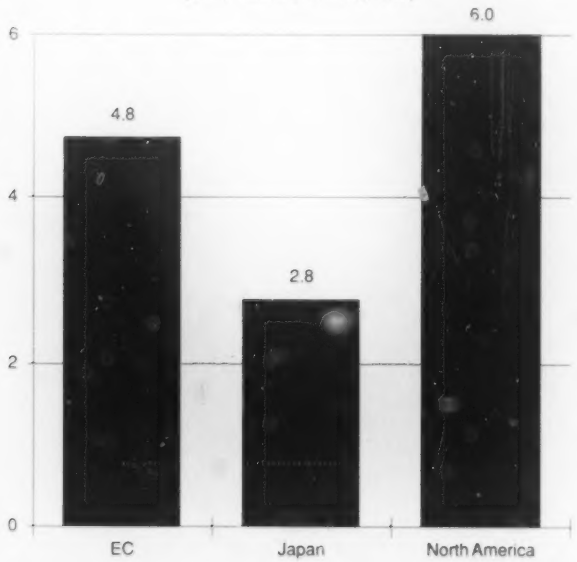
U.S. Current-Account Deficit Decline Continues During 1990-92

Our forecast is for the U.S. merchandise-trade and current-account deficits to continue to decline in the near term. The decrease in the trade deficit from $115 billion in 1989 to an estimated $104 billion in 1990 and $97 billion in 1991 largely reflects the slower growth of the domestic economy, which results in slower import growth. The effect of the Middle East crisis on the trade account is primarily an increase in the cost of petroleum and related products, which would keep the deficit higher than otherwise.

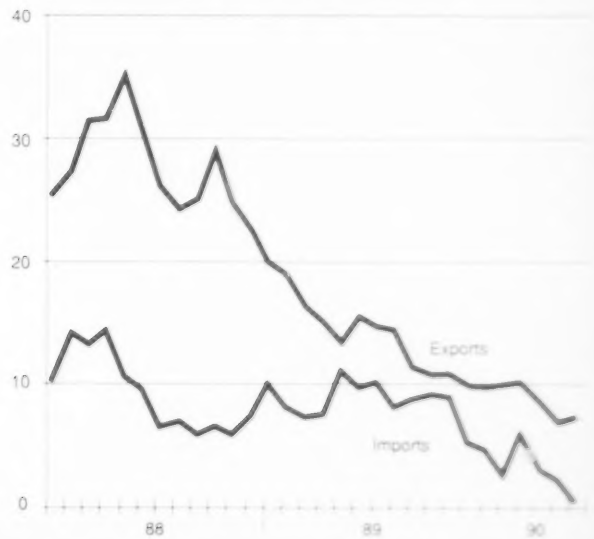
As the accompanying chart shows, both U.S. export and import demand have been decelerating as the effects of the large depreciation of the U.S. dollar in 1985-86, which made U.S. exports more competitive internationally and U.S. imports more expensive, were largely exhausted. In 1992, we look for U.S. import demand to increase from 1990-91 rates as the economy resumes a stronger growth path, while export growth remains healthy.

During 1988-90, we have witnessed strong U.S. export growth concen-

North America Would Be Largest Free-Trade Area
(GNP, trillions of dollars, 1989)



U.S. Export and Import Growth Has Slowed Since Early 1988
(Percent change in 3-month moving average from prior year)



trated in consumer goods (excluding autos), and capital goods. During 1989, when merchandise exports on a census basis increased 13%, consumer-goods exports rose nearly 42% and capital goods 13%. So-called "other" (a residual category) exports increased nearly 17%. During the first half of 1990, a similar pattern is developing. While general exports rose 8% from the year-earlier level, consumer-goods exports increased 20% and capital goods, 13%. "Other" exports rose 25%.

Recent revisions of U.S. balance-of-payments data have resulted in a substantial lowering of the services-account surplus for 1987-88. For 1987, for example, the surplus was revised down from $19 billion to less than $12 billion. Within a year, we may again see revisions to the 1988-89 data, which would presumably lower the surplus once again. With the negative net U.S. investment position rising by approximately $100 billion in both 1990 and 1991, the surplus on the services account should continue to trend downward. The June 1990 release for the U.S. international investment position for 1989 did not give a net number because of basic data incompatibility.

One effect of the Middle East crisis is likely to be on the transfers account. At present it is difficult to estimate what the cost of U.S. involvement will be, but it is fairly clear that U.S. unilateral transfers abroad will be larger than they would have been prior to the August 2 Iraqi invasion of Kuwait. Payments to Egypt, Jordan, Turkey, and elsewhere will mount the longer the crisis persists.

The current-account deficits forecast for 1990-92 represent a substantial decline from the $162 billion deficit recorded in 1987. In 1987, the deficit was the equivalent of 3.6% of GNP; in 1990, it has decreased to 1.9%; in 1992, to 1.5%.

If the situation in the Middle East is not resolved relatively quickly, then it is difficult to predict what the net effects would be on the 1990-91 trade and current-account deficits. Oil prices would remain higher than we are forecasting, raising the cost of energy imports. A prolonged stalemate, however, would also likely lower U.S. real economic growth, which would decrease U.S. import demand, including that for fuels. The cost of imports could also be higher if the dollar proves to be weaker than forecast. A longer, drawn out crisis also probably implies that the transfers deficit for 1990-91 would be larger than otherwise. On balance, the current-account deficit would probably be larger than that currently forecast for 1990-91.

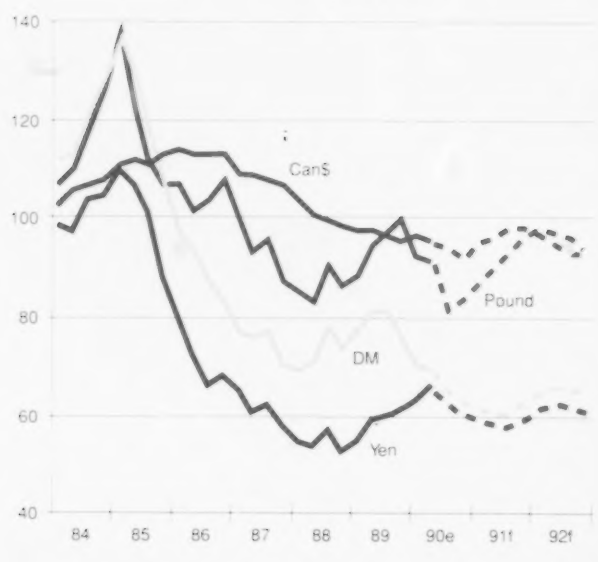
Dollar to Weaken in the Near Term, Strengthen After

Unlike the usual case where the dollar strengthens during times of international crisis, the dollar essentially weakened against most major currencies after the Middle East crisis commenced. In this instance, the markets recognized that the United States stood to lose the most among the Western powers in the confrontation. The markets have taken account of the fact that the Saudis are supplying fuel for armed forces stationed on Saudi territory and the Kuwaitis have said that they would reimburse the United States for costs involved in the crisis. Nevertheless, the predominant share of personnel, arms, and materiel confronting the Iraqis belongs to the United States.

We look for the dollar to weaken against both the yen and the deutschemark into the second quarter of 1991. Our forecast is for U.S. short-term interest rates to fall and bottom out in the second and third quarters of 1991. Initially, interest rates will decline faster than inflation as the Federal Reserve allows short-term rates to decline in an attempt to keep the economy from drifting into recession. Starting in the fourth quarter of 1991,

U.S. Dollar to Weaken During Near Term Against Yen and Mark

(Index, 1983=100, quarterly average)



however, real short-term rates will increase, which will provide support for the dollar. At the same time, interest-rate increases abroad are likely to be matched by higher inflation. An additional factor supporting the dollar will be the continuing decline in the U.S. current-account deficit during 1990-92. With smaller current-account deficits, the United States will have to attract less capital inflow.

On the other side, we believe that foreign interest rates will generally rise as countries institute policies to diminish inflation pressures. Foreign interest rates are likely to rise faster than inflation initially. Consequently, real interest rate differentials will move against the dollar for several quarters. Our expectation is that the Bank of Japan (BoJ) has only begun its struggle to reduce money-supply growth rates to try to constrain building inflation pressures. Money-supply growth rates were at double-digit levels for the first seven months of 1990. For months, the BoJ was loath to tighten because of the effects that higher interest rates might have on the Tokyo stock market. The Middle East crisis solved much of that problem, as can be seen in the chart comparing price/earnings ratios for the S&P 500 and the Nikkei (Tokyo's stock market index). Although the Nikkei has further to decline to bring P/E ratios for the two markets into basic alignment, the BoJ cannot afford to postpone tightening its policies much longer if it is not to face a considerably worsened inflation situation in 18-24 months. As indicated above, we look for Japan's current-account surpluses to trend downward during 1990-92.

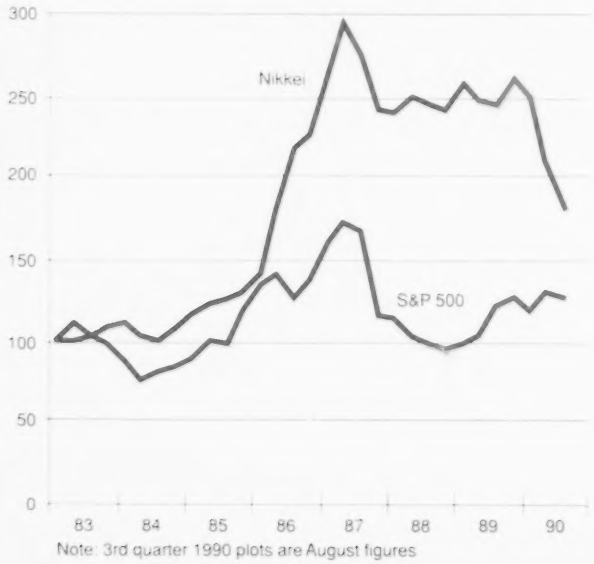
In Germany, the economic effects of unification are beginning to be felt, and inflation will rise, forcing the Bundesbank to take appropriate action. The German current-account surplus in 1990 is increasing from its 1989 level before it begins to decline during 1991-92.

Our forecast is for the dollar to depreciate approximately 12% against the yen and the mark by the second quarter of 1991 from its averages one year earlier. Despite this depreciation, the dollar would still be about 9% higher than the quarterly-average low it reached against the yen in the fourth quarter of 1988. From its low against the yen and the mark recorded around mid 1991, we look for the dollar to appreciate against both currencies through end 1992. It would appreciate approximately 8.5% against the yen and 7.5% against the mark.

If the Middle East crisis proves to be more protracted than assumed in our baseline forecast, the dollar will likely depreciate faster than indicated. Such a scenario implies that oil prices would remain higher than otherwise; hence, inflation would be higher than forecast. This scenario would raise the likelihood of a U.S. recession, which would lead the Federal Reserve to adopt a more expansive monetary policy. Real interest rates would erode more during the near term than under the baseline forecast, leading to a more rapid erosion of support for the dollar. We do not believe, however, that the dollar would fall below the bottom levels indicated above, unless there is another substantial ingredient added to the picture that is negative for the U.S. currency.

Price/Earnings Ratio Differential for Nikkei and S&P 500 Narrowed Sharply in 1990

(Index, 1st quarter 1983=100, quarterly average)



Note: 3rd quarter 1990 plots are August figures

First Interstate Territory

The 20-state First Interstate Territory matched the nation's employment growth in 1988 and surpassed it in 1989. We expect the Territory to retain a positive growth margin over the rest of the country through 1992. Our forecast is for the Territory's employment to grow 1.7% in 1991 and 2.4% in 1992. Each of these rates would be 0.6 percentage point above the national averages.

The slump in the U.S. economy will affect Territory states through the middle of 1991 because of the impact on durable-goods manufacturing, housing, metal prices, and tourism. Oil prices averaging $20 a barrel or higher will help the Rocky Mountain and Southern Tier states to recover. Continued growth abroad and the dollar's recent decline on foreign-exchange markets will support export demand for a number of Territory states.

Real estate markets vary widely within the Territory. Although home prices have picked up in Houston, they remain weak in other parts of the Southern Tier. California's coastal cities have experienced some price correction in housing after two years of boom, while prices in less expensive inland areas of the state are soaring, as are those in the Pacific Northwest.

Territory Outpaces Nation

First Interstate currently has affiliate banks and franchise relationships with banks in 20 states. This Territory will produce nearly $2 trillion of goods and services in 1991, accounting for over a third of total U.S. GNP.

Employment growth in FI Territory fell behind the national average during the mid 1980s, with the end of the commodity price boom, which had accelerated the region's prior expansion. The Territory caught up with the nation in 1988 in employment growth, however, and surpassed it in 1989.

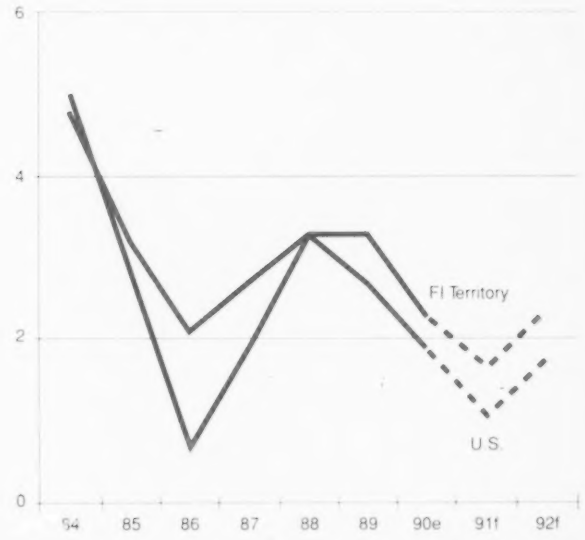
We estimate that nonfarm payroll employment for 1990 will increase an average of 2.3% in FI Territory versus a national gain of 1.9%.* Projected Territory advances of 1.7% and 2.4% in 1991 and 1992, respectively, will exceed the U.S. gains by a margin of 0.5 to 1.0 percentage point each year.

Some improvement in productivity should offset a slowing in Territory job growth from 1990 to 1991 and allow personal income to expand by 6.7% in both years. We then look for income growth to pick up to 7.5% in the Territory during 1992.

**Most of the figure in this section are expressed in terms of annual averages, whereas the numbers in the "U.S. Economy" section were generally on a fourth-quarter-to-fourth-quarter basis.*

FI Territory Holds Growth Edge

(Percent change in nonfarm employment from prior year)



Early Census Readings

Although subject to revision before yearend, preliminary 1990 Census results indicate that the population of FI Territory expanded at a rate nearly twice the national average during the past decade. The Territory's population climbed 15.4% between 1980 and 1990, an average annual rate of 1.4%, while the national population increased 8.5% over the ten years, an annual rate of just 0.8%.

Of the ten fastest growing states over the period, seven are in FI Territory: Nevada, Alaska, Arizona, California, Texas, Utah, and Washington. The non-Territory states were Florida, New Hampshire, and Georgia. Nevada experienced the most rapid population growth in the nation, with an average annual gain of 4.1%.

California continues to be the most populous state and widened its margin over New York considerably during the ten years. The preliminary Census numbers place California's population at 29.3 million for 1990, versus 17.6 million for New York. Texas is third with 16.8 million residents.

POPULATION IN FI TERRITORY

	1980 (thous)	1990* (thous)	% change (avg. ann)
AK	402	546	3.1
AZ	2,718	3,619	2.9
CA	23,668	29,279	2.2
CO	2,890	3,272	1.3
HI	965	1,095	1.3
ID	944	1,004	0.6
IN	5,490	5,499	0.0
IA	2,914	2,767	-0.5
LA	4,206	4,181	-0.1
MT	787	794	0.1
NV	800	1,193	4.1
NM	1,303	1,490	1.4
ND	653	634	-0.3
OK	3,025	3,124	0.3
OR	2,633	2,828	0.7
SD	691	693	0.0
TX	14,229	16,825	1.7
UT	1,461	1,711	1.6
WA	4,132	4,827	1.6
WY	470	450	-0.4
FI Territory	74,381	85,831	1.4
U.S.	226,546	245,838	0.8

* Preliminary Census

Forces Shaping the Territory's Outlook

Several external forces will affect performance of the various Territory states in 1991-92. With the exception of Alaska, which follows its own cyclical pattern heavily affected by oil prices, all of the FI states are influenced significantly by national macroeconomic conditions. A slowing in average U.S. job growth in 1991 and a subsequent pickup in 1992 constitute a key element in the state forecasts.

The dependence of a number of Territory states on energy production makes the price of oil and its substitutes another primary factor. Our assumption that the price of West Texas Intermediate crude oil will average about $20 a barrel in 1991 and $21 in 1992 will be moderately good news for a number of areas. Natural gas producers are also likely to see a better price for their output. Higher energy prices will benefit a number of states in the Rocky Mountains and the South, although adversely affecting some states ranging from Indiana to Oregon and Hawaii.

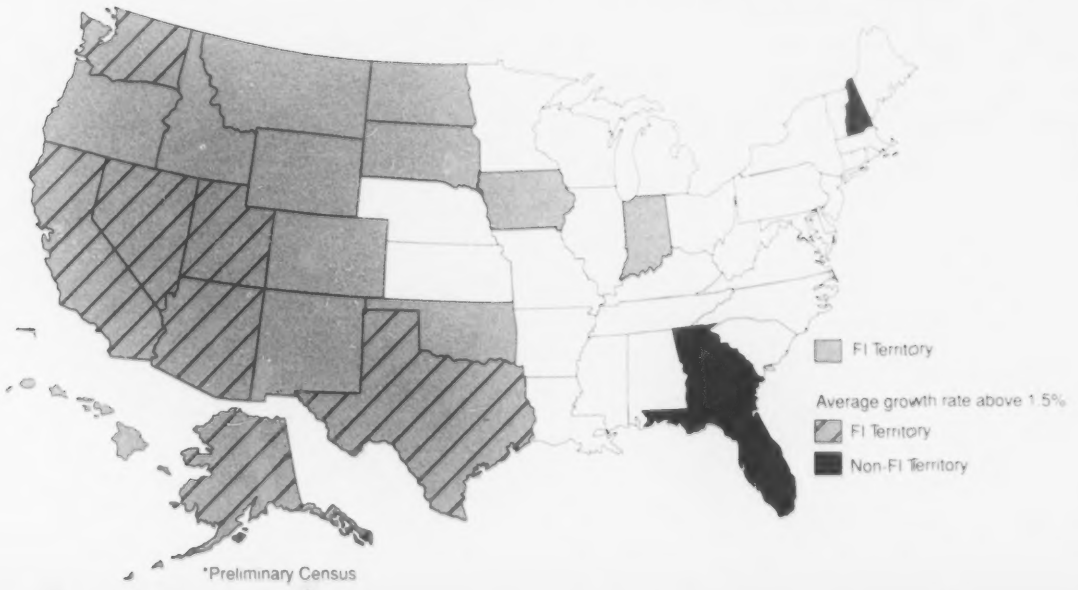
Although Territory states produce a wide diversity of agricultural commodities, we assume a general trend of modest growth in farm prices. Record harvests, however, will depress wheat and corn prices in the near term.

An easing of inflationary concerns and a slowing of the economy in the near term will likely dampen metal prices through the first half of 1991. A pickup in economic activity should then revive metal markets somewhat by the end of next year, although demand for precious metals as an inflation hedge will be minimal.

Exchange rates affect a number of Territory states, ranging from Nevada and Hawaii through the impact on

High Growth States Concentrated in FI Territory

(States with highest 10-year population growth through 1990*)



tourism to Iowa and Washington through the influence on exports. The dollar's recent decline on foreign-exchange markets will help bolster activity in a number of states.

Several Territory states are affected by trends in U.S. housing construction. These include the Pacific Northwest states heavily engaged in lumber and wood products, as well as manufacturing states with a concentration in home appliances, such as Indiana. A modest improvement in housing starts from 1990's cyclical low will provide some encouragement to these states next year, but housing will not return to a more satisfactory level until 1992.

Defense spending is unlikely to dominate the economic outlook for any of the Territory states, although there will be effects on firms and local areas in several parts of the FI region. We do not expect the Middle East situation to reverse the downturn in defense outlays, although the real rate of decline may be 2-3% per year in the near term, in contrast to the 5% rate previously assumed by some business planners.

The overhang of unleased space will continue to constrain new construction in some parts of the Territory, ranging from Arizona to Texas. However, lower rents relative to other regions will help attract businesses expanding or relocating operations.

The Territory's Five Regions

For the purpose of analysis, the Territory states are divided into five regions: Pacific Southwest (Arizona, California, Hawaii, and Nevada); Pacific Northwest (Alaska, Idaho, Oregon, and Washington); Rocky Mountains (Colorado, Montana, New Mexico, Utah, and Wyoming); North Central (Indiana, Iowa, North Dakota, and South Dakota); and Southern Tier (Louisiana, Oklahoma, and Texas). The table at the end of this section shows employment and income forecasts for each of the states.

Pacific Northwest

The Pacific Northwest and Rocky Mountain area will record the highest employment growth rates in the FI Territory in 1991-92. However, while growth in the Rocky Mountains will represent continued recovery from a depressed base, the performance of the Northwest will be a moderation in growth from the recent unsustainable pace.

After forging ahead at an average rate of 4.6% during the three years ending in 1990, we look for payrolls in the Pacific Northwest to advance 2.3% in 1991 and 2.9% in 1992. A slower national economy and environmental constraints on the supply of timber will limit the region's growth. Each of the region's four states, however, possesses definite positives: Commercial aircraft backlogs and exports will bolster Washington; Southern Idaho's high-tech industry will make further strides; Alaska will benefit from North Slope oil and gas development, tourism, and its seafood industry; and Oregon will see further population growth with an attendant demand for construction, trade, and services.

We look for sizable personal income growth in the Pacific Northwest in 1991--7.5% in Washington and Alaska, 7.1% in Oregon, and 6.2% in Idaho. These gains will all be above the 5.9% national average.

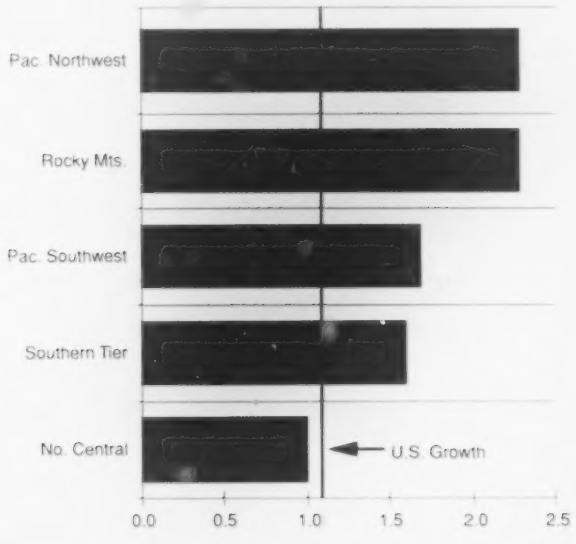
Rocky Mountains

If our assumptions are correct, 1991 will mark the third consecutive year that oil prices have averaged close to $20 a barrel. Although certainly not sufficient to revive the prior boom, such a price level will support a moderate amount of oil and gas exploration and development. Coal should also benefit from markets in the Far East. Consequently, we look for job growth of about 2.3% in the Rocky Mountain area in 1991 and 3.0% in 1992, both rates above those expected for the nation.

Utah's construction, retailing, and

Pacific Northwest and Rocky Mountains Lead in 1991

(Percent change in nonfarm employment)



services sector will continue to benefit from population gains, although growth will moderate from the recent pace. Colorado's economy has been slow to recover, but it should begin to show a more favorable performance. Defense cuts are expected to retard New Mexico's upturn, but job gains should continue. Wyoming will continue to look to tourism, as will all of the Rocky Mountain states. Montana will share the log supply problems faced by its neighbors in the Pacific Northwest.

We expect personal income in the Rocky Mountain area to advance by 6.6% in 1991. The process of recovery will generate above-national gains in Colorado and New Mexico, while Utah is likely to exceed the national average for the third consecutive year.

Pacific Southwest

We expect job growth in the Pacific Southwest to average 1.7% in 1991 and 2.3% in 1992. Nevada will see a moderation in its boom driven by construction for the gaming/tourism industry, but the state is likely to continue to be one of the fastest growing in the nation. Despite difficulties in real estate, Arizona has experienced steady and sizable job growth, a trend forecast to continue. California's economy will follow the nation fairly closely with slower job growth in 1991. Hawaii is likely to see a further slowing in travel from the mainland United States in the coming year, but tourism from Asia should be substantial.

All of the states in the Pacific Southwest will achieve personal income gains above the national average in 1991. Nevada will lead with a climb of 9.7%, following leaps of 12-14% in the prior three years.

Southern Tier

Higher energy prices should help recovery in the Southern Tier, with employment growth of 1.6% in 1991 and 2.6% in 1992. Texas has already achieved three years of moderate growth, helped in part by the attraction of firms to the lower cost of land and housing. The state should now outperform the nation during the next two years. Oklahoma's economy has been somewhat slower to recover, but it should benefit from higher oil and natural gas production in 1991-92. Louisiana has been the weakest of the three states, but it should also improve in the next two years.

Oil and gas royalties will continue to affect income growth substantially in the Southern Tier states. Our forecast is for an income gain of 6.7% in 1991, up from the 6.0% rise estimated for 1990.

North Central

Agriculture will be a key factor determining the outcome for the states in the North Central area during the next two years. We expect the region's job growth to trail slightly the national pace, with employment gains of 1.0% in 1991 and 1.7% in 1992. Iowa, Indiana, and South Dakota all recorded sizable growth in total nonfarm employment in 1989.

Manufacturing will be weak in this region until the U.S. economy begins to recover. North Dakota should benefit, however, from relatively high oil prices. Although the rebound from the 1988 drought pushed up the region's personal income a strong 8.2% in 1989, we look for a moderate gain of 5.8% for all of 1990 and 5.4% in 1991.

Real Estate Trends Mixed

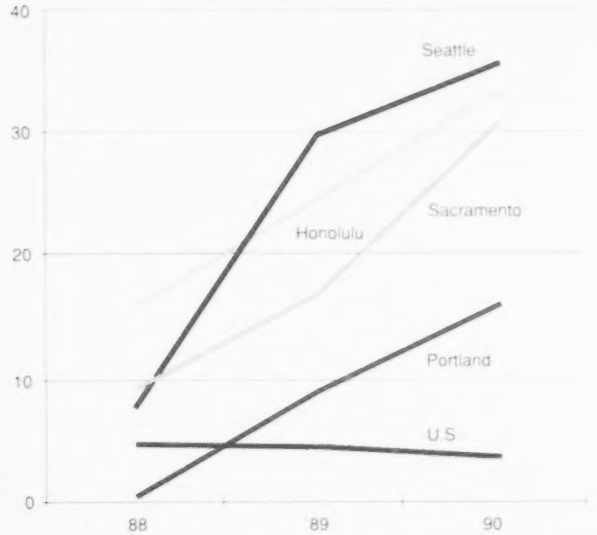
Housing--Boom, Bust or Steady?

The Territory's residential real estate market is currently characterized by widely diverging patterns. During the first half of 1990, sales of existing single-family homes and condominiums were flat or below their year-ago levels in California, Colorado, Iowa, Indiana, and Louisiana. At the same time, the rapidly expanding economies of Nevada and the Pacific Northwest (Idaho, Oregon, and Washington) produced sales gains of 25-35%.

Home price changes have demonstrated similar disparity. As of the

Hottest Housing Markets

(Home prices, percent change from prior year)



Source: National Association of Realtors

Weakest Housing Markets

(Home prices, percent change from prior year)

second quarter of 1990, prices of existing single-family homes declined in a number of metropolitan areas in the Southern Tier states of Texas and Louisiana, as well as in California. Prices in the Houston area appear to be recovering, however, with a year-to-year gain of 4% in the second quarter and 8% for the entire first half of 1990. The generally weak performance of home prices in the South is an extension of the trend of the past two years. In contrast, this year's declines in prices in the coastal areas of California, including Los Angeles and San Francisco, represent corrections after two years of 20%-plus annual rates of appreciation.

Honolulu prices, driven in part by foreign investment, continued to climb rapidly in this year's first half. Some of the hottest housing markets, however, have now developed in such areas as Sacramento, Portland, and Seattle, where potential homebuyers have sought less expensive housing than they can find in the larger California metropolitan regions.

Which markets could be vulnerable to a downturn? Further declines in the Japanese stock market could dampen foreign investment in the Hawaiian market, although some investors may continue to seek diversification out of Japan. The rates of sales and price increases experienced in the Pacific Northwest are unsustainable. However, because prices remain well below California levels, rates of change may only moderate, rather than turn negative.

In contrast to a national trend of lower housing permits for new construction, several Territory states have registered sizable increases in 1990. Many of these gains have been in the Pacific Northwest and Rocky Mountain states, reflecting economic upturns or improvements in those areas. South Dakota has experienced the largest percentage jump in housing permits this year among the Territory states. Housing permits in Texas, after falling for five years in a row, finally edged up 2% in 1989 and rose a strong 23% in the first half of 1990.

Housing permits have declined during 1990 in California, Hawaii, Nevada, North Dakota, Louisiana, and Oklahoma. The severe imbalances that plagued New England in the mid 1980s, when two housing units were built for each household formed, do not currently exist in FI Territory. Where new housing units had begun to run ahead of new household formation in such areas as Nevada, Louisiana, and Hawaii, the cutback in 1990 development should help correct a possible buildup of inventory.

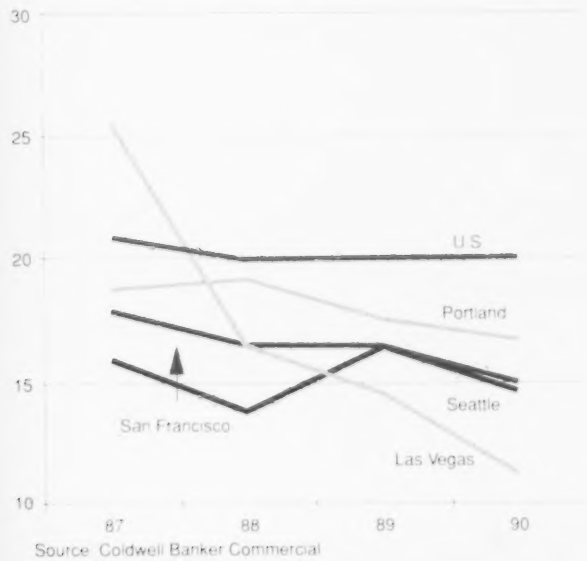
Nonresidential Real Estate--How Much Vacant Space?

The Territory also displays substantial divergence with respect to nonresidential real estate. Office vacancy rates remain above the national average in Texas, Oklahoma, Colorado, and Arizona. Metropolitan areas such as Houston, Oklahoma City, and Denver have, however, experienced reductions in their vacancy rates. Absorption is running at a high pace in Phoenix, but it has still recently been outpaced by the completion of projects previously started. In contrast, office vacancy rates remain below the national average in Las Vegas, Seattle, Los Angeles, San Francisco, and Portland.

Nationally, the industrial sector is somewhat less overbuilt than the office segment, and the same is true within FI Territory. Industrial construction, for example, has increased this year in Texas and Oklahoma. Huge gains were recorded during the first half of 1990 in Indiana, South Dakota, Idaho, and Alaska. As of the middle of 1990, numbers published by Coldwell Banker showed industrial vacancy rates in the Territory ranging from a low of 1.4% in Portland to a high of 9.8% in Oklahoma City; the national average was 6.8%.

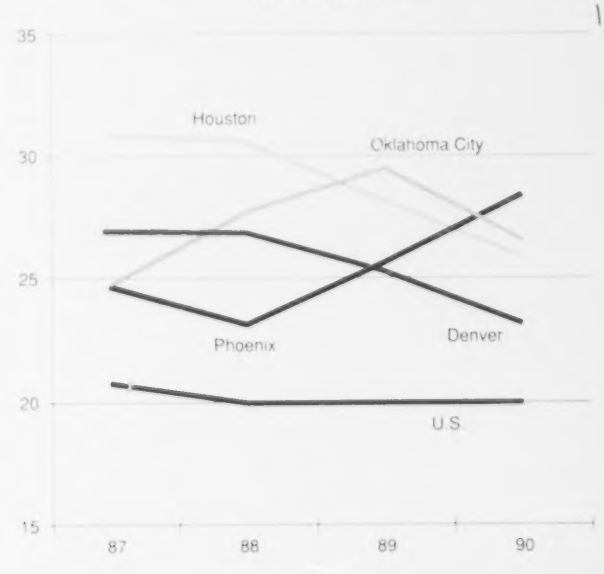
Lowest Office Vacancy Rates

(Percent, June 30)



Highest Office Vacancy Rates

(Percent, June 30)



Source: Coldwell Banker Commercial

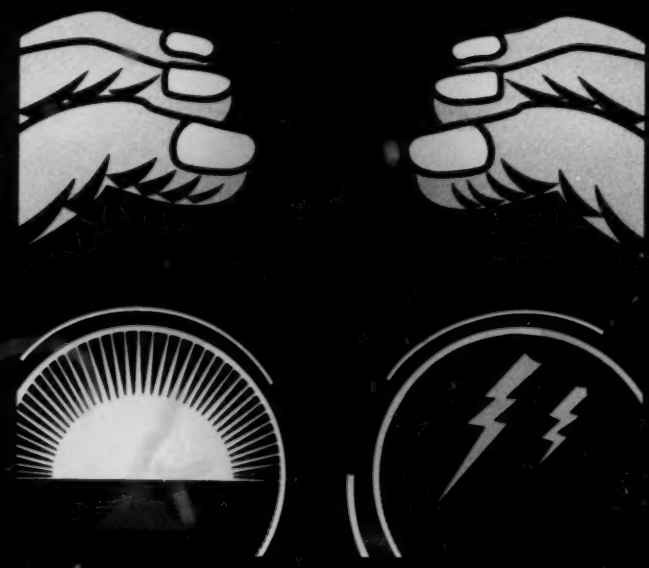
NONFARM PAYROLL EMPLOYMENT

	1989		1990e		1991f		1992f	
	Thousands	% Change	Thousands	% Change	Thousands	% Change	Thousands	% Change
Alaska	227	6.4	235	3.3	239	2.0	245	2.1
Arizona	1,457	2.7	1,498	2.8	1,535	2.4	1,593	3.8
California	12,588	4.0	12,878	2.3	13,071	1.5	13,332	2.0
Colorado	1,472	2.5	1,500	1.9	1,534	2.3	1,580	3.0
Hawaii	505	5.6	520	3.1	532	2.2	542	2.0
Idaho	367	5.4	384	4.6	392	2.0	404	3.0
Indiana	2,467	3.0	2,498	1.2	2,518	0.8	2,556	1.5
Iowa	1,200	3.8	1,224	2.0	1,237	1.0	1,258	1.7
Louisiana	1,516	0.3	1,526	0.6	1,556	1.9	1,578	1.4
Montana	291	2.7	295	1.6	297	0.5	301	1.5
Nevada	582	8.3	621	6.7	649	4.5	683	5.2
New Mexico	561	2.4	571	1.8	583	2.2	599	2.7
North Dakota	260	1.4	267	2.4	271	1.5	278	2.5
Oklahoma	1,154	2.0	1,168	1.2	1,188	1.7	1,219	2.6
Oregon	1,207	4.4	1,248	3.4	1,275	2.2	1,315	3.1
South Dakota	275	3.3	281	2.1	285	1.5	292	2.4
Texas	6,810	2.0	6,926	1.7	7,037	1.6	7,234	2.8
Utah	691	4.7	722	4.5	745	3.2	771	3.5
Washington	2,045	5.3	2,138	4.5	2,192	2.5	2,253	2.8
Wyoming	194	2.4	196	1.2	200	2.4	207	3.5
FI Territory	35,869	3.3	36,696	2.3	37,334	1.7	38,237	2.4
U.S.	108,413	2.7	110,453	1.9	111,631	1.1	113,632	1.8

PERSONAL INCOME

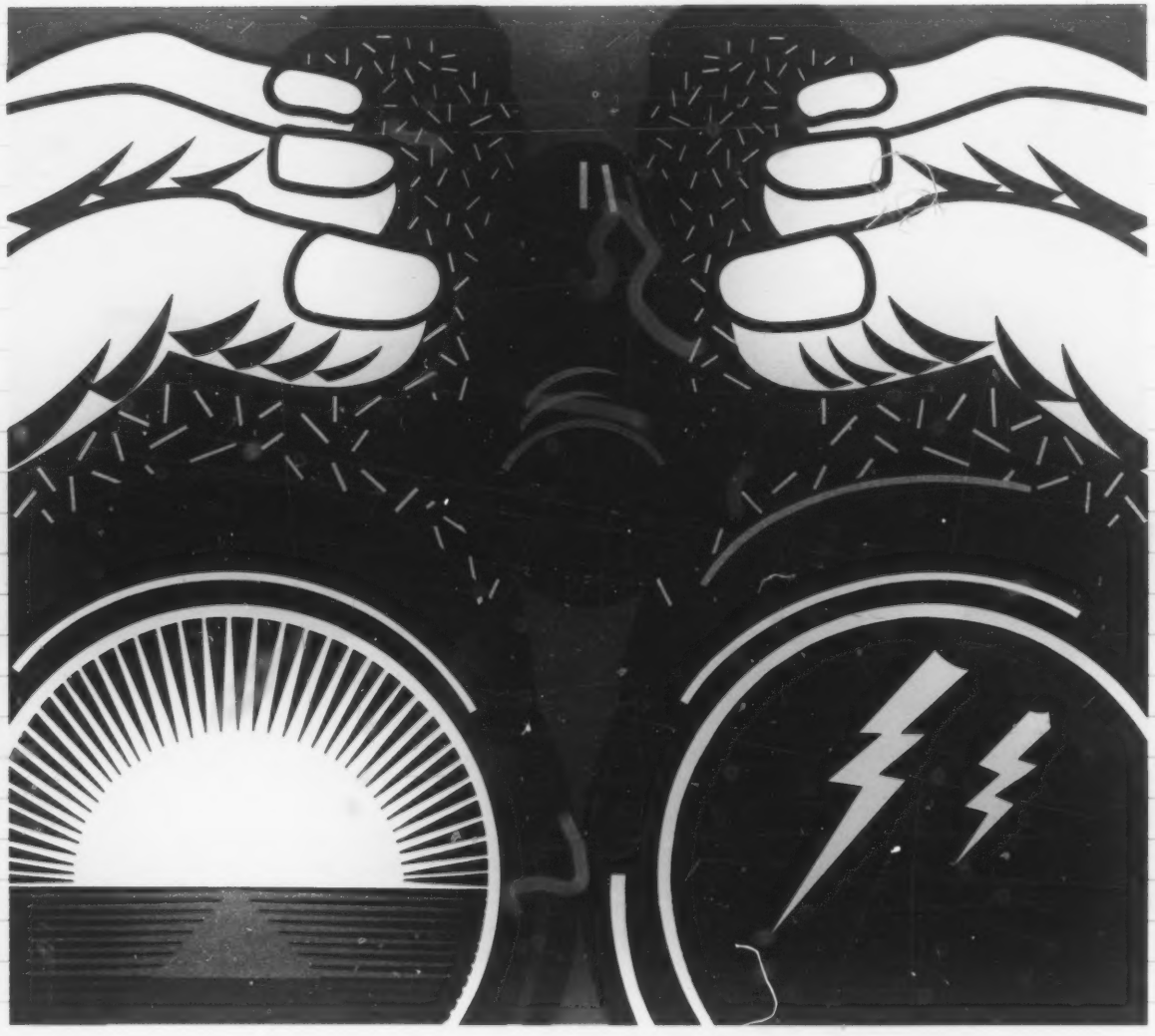
	1989		1990e		1991f		1992f	
	$ Billions	% Change	$ Billions	% Change	$ Billions	% Change	$ Billions	% Change
Alaska	11.4	13.0	12.4	8.3	13.3	7.5	14.3	7.6
Arizona	56.2	7.6	60.2	7.0	64.5	7.2	69.5	7.8
California	579.2	8.1	618.6	6.8	660.0	6.7	709.5	7.5
Colorado	58.2	7.1	61.7	5.9	65.9	6.8	70.9	7.6
Hawaii	20.5	11.3	22.2	8.3	23.9	7.5	25.7	7.4
Idaho	13.9	9.6	15.1	8.5	16.0	6.2	17.2	7.3
Indiana	88.3	7.8	93.0	5.4	98.0	5.3	104.0	6.1
Iowa	44.0	8.5	46.8	6.5	49.4	5.5	52.6	6.4
Louisiana	56.6	5.0	59.5	5.0	63.3	6.5	67.2	6.2
Montana	11.3	9.5	12.0	5.5	12.5	4.8	13.3	5.9
Nevada	21.4	13.7	23.9	11.7	26.2	9.7	29.0	10.5
New Mexico	20.1	7.2	21.2	5.7	22.6	6.7	24.2	7.1
North Dakota	9.0	8.7	9.5	5.9	10.0	5.6	10.6	6.2
Oklahoma	45.6	6.1	47.7	4.6	50.4	5.6	53.7	6.6
Oregon	44.9	9.5	48.3	7.7	51.8	7.1	55.9	8.0
South Dakota	9.8	8.8	10.3	5.6	10.9	5.3	11.6	6.3
Texas	266.8	7.4	284.1	6.5	303.8	6.9	328.7	8.2
Utah	22.3	8.0	24.0	7.7	25.7	6.9	27.6	7.4
Washington	84.0	10.4	91.8	9.2	98.7	7.5	106.6	8.0
Wyoming	6.9	4.6	7.2	4.7	7.6	5.9	8.2	7.2
FI Territory	1,470.4	8.1	1,569.6	6.7	1,674.5	6.7	1,800.2	7.5
U.S.	4,368.1	7.6	4,634.6	6.1	4,908.0	5.9	5,237.0	6.7

Note: Calculations based on unrounded data.



First Interstate Bancorp

FORECAST
1991-1992



UPDATE

February 1991

First Interstate Territory Edition

First Interstate Bancorp

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Overview

The resiliency of the U.S. economy will be tested in 1991. Once the depressing effects of war fears, restrictive monetary policy, and high oil prices are lifted, we believe this resiliency will result in a return to growth.

Without the Middle East crisis, the economy would probably have been flat in the second half of 1990, and an actual contraction would have been avoided. Savings and loan industry problems, regulatory pressures on banks, high corporate indebtedness, the fiscal fiasco and mushrooming federal budget deficit, and restrictive monetary policy were enough to retard growth from the normal 2.5-3.0% rate to about zero.

We believe that the "oil shock" stemming from the invasion of Kuwait and the plunge of business and consumer confidence as the crisis deepened were key factors that caused real GNP to contract in the fourth quarter of 1990 and in early 1991. If this interpretation of recent events is correct, the end of the conflict will be followed by an early end to the recession.

The cessation of hostilities should result in a resumption of postponed hiring, ordering, and capacity expansion by business. A pickup in household spending for autos, appliances, and other consumer durables will also contribute to positive real output growth for the second quarter.

Inflation this year will be below last year's rate. The "oil shock" in 1990 added 1.5-2.0 percentage points to the rise in the consumer price index for the year. With falling oil prices this year, the measured inflation rate will be biased to the low side. From year-end to year-end, consumer prices are expected to rise less than 4%.

Lower inflation ensures that interest rates will remain lower than they were previously. Long-term bond yields will fall in the weeks ahead as oil prices and inflation decline. Short-term market rates may have already seen their lows for the year if the rebound in economic activity strengthens credit demands quickly.

The weakness of the housing and automobile industries in late 1990 was partially attributable to war fears. The end of hostilities is expected to be followed by at least modest increases in auto sales and production, home sales, and housing starts. Industries whose sales are closely related to consumer spending, such as furniture and appliance manufacturing and retail trade, should also see moderate increases in demand in the months ahead. Telecommunications, pharmaceuticals, and food processing are among those industries likely to experience stronger growth in sales and production this year.

In 1991, the deposit insurance fund will be recapitalized in order to cope with continuing bank failures. As bank earnings improve and capital ratios rise, concerns over credit availability will diminish. Federal legislation appears very likely to permit interstate branch banking, enhancing the efficiency and stability of the financial system.

Abroad, economic growth has been slowing in most major industrial countries. A few of them, including the United Kingdom and Canada, are experiencing recessions. Nevertheless, growth in Germany and Japan is expected to remain positive, maintaining world trade growth and helping to narrow the U.S. trade deficit further. The dollar fell considerably on foreign-exchange markets during the Middle East crisis. The final phase of the war was accompanied by a recovery of the dollar. Lower inflation this year should offset some negative effects on the dollar from lower bond yields. As short-term interest rates in this country begin to rise later in the year, the dollar could rise after an initial period of weakness during the second quarter.

First Interstate Territory

During the past two years, First Interstate Territory exceeded the U.S. average in employment and income growth. This pattern is expected to continue in 1991-92. Because of the sharp deceleration of economic activity in late 1990 and early 1991, all Territory states will show slower job growth in 1991 compared with last year before improving in 1992. The trend will be improving as 1991 progresses, but from a depressed starting point early in 1991.

The Pacific Northwest will be the strongest region, although the modest expansion of the housing market will constrain the lumber and wood-products industry. Higher oil prices last year helped the Rocky Mountain and Southern regions. Any sustained drop in oil prices this year would retard the recovery in energy producing areas. A bounce back of tourism will, however, help a number of states in the Rocky Mountains and the Pacific Southwest. California will record only a small increase in employment this year. The state's economy will track closely the moderate pace of recovery of the national economy. North Central states have benefited from an improvement in the farm sector, but grain prices could again be eroded by an abundant harvest.

February 28, 1991

The U.S. Economy

Pulse of the National Economy

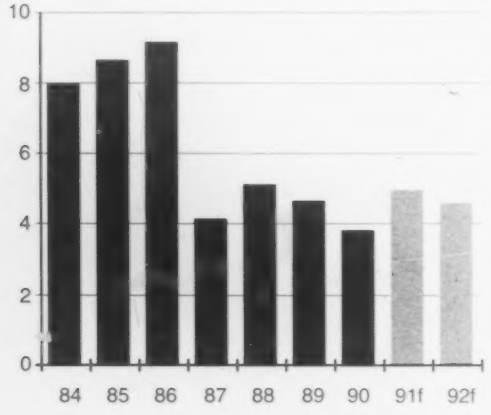
The downturn in the U.S. economy has now been sufficiently deep, long, and widespread to qualify as a bona fide recession. Whereas most of the job losses have been in manufacturing and construction, work forces have also been cut in various parts of the service sector, ranging from wholesaling and retailing to financial and business services. Only health care seems to have been immune to significant layoffs.

The economy had been decelerating since 1987, when real GNP growth peaked at 5.0%. Last year, real GNP edged up only 0.4%. On a quarterly basis, growth has remained below a 2% annual rate since early 1989, finally turning negative in the last three months of 1990.

Two primary forces pushed the economy into recession last year: restrictive monetary policy and the Middle East crisis. Since 1987, the Federal Reserve has restrained reserve and money growth in an effort to curb inflationary pressures. Bank reserves increased only 0.3% in 1990, while the broader measure of the money supply, M2 (currency, checking & savings accounts, and small CDs), expanded only 3.9%, the slowest growth rate in at least 30 years. Contrary to the common perception that tighter bank lending standards have been the main cause of the slowdown in money and credit growth (the "credit crunch" theory), the root cause of that slowing was the Fed's low injection of reserves into the banking system. The monetary authorities resisted market pressures leading to lower short-term interest rates, bringing the annual rate of growth in M2 to well below their own target range (3-7%) by the fourth quarter. Money growth continued weak in January but began to accelerate in February. The Fed has now probably set its interest rate target sufficiently low to foster a sharp increase in monetary stimulus.

Fed Less Restrictive in 1991

(Percent change in M2, 4th quarter to 4th quarter)



Monetary policy might have succeeded in purging the remaining inflationary forces in the economy without reducing real output had it not been for Iraq's invasion of Kuwait last August 2. Our estimates show that without the impact of the Middle East crisis, real GNP would have been about flat instead of declining at an annual rate of 2.0%, as indicated by the revised estimates of GNP for the fourth quarter of 1990. Because the United States is a net energy importer, a wealth loss occurred when oil prices suddenly jumped. This loss was reflected in a decline in real incomes for households and, subsequently, in lower consumer spending. Plunging consumer confidence magnified the drop in consumer outlays for durable goods, nondurables, travel, and other services, as well as aggravating weakness in the housing market.

Although recent news on the economy has been almost uniformly negative, certain factors should help bring the recession to an end. First, ending of the war should trigger a rebound in consumer and business confidence. Lower oil prices will also help boost real income and spending. Second, the Federal Reserve has responded to the downturn and begun to revive bank-reserve and money growth. Bank lending standards are likely to remain more conservative than in the past, but that change will imply generally greater collateral and equity requirements, rather than a total shutdown of new credit. Non-bank institutions may also assume a greater role in lending. Third, inventories were held at low levels, even in the face of weak final demand, as firms reacted quickly to slowing orders and sales. Further massive cuts in output and employment will thus not be necessary to slash stocks of unsold goods. Fourth, the dollar's decline last year will help to bolster exports, while also helping firms that compete against imports.

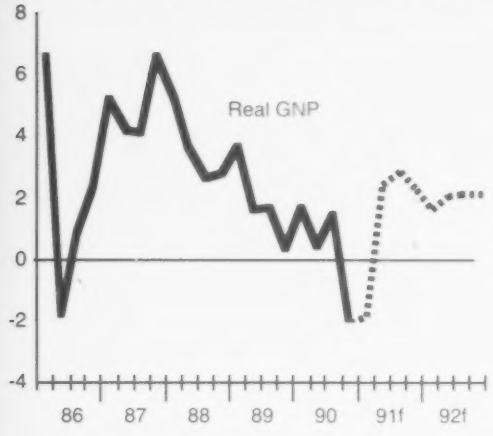
Two key factors will temper the pace of the eventual recovery. First, debt loads did increase during the 1980s for corporations and households, which could limit new investment and spending. Gains in the stock market and/or real estate values will, however, improve debt/equity positions. Second, the excess supply of office, other commercial, and hotel space will limit new nonresidential construction. Although such building constitutes less than 3% of real GNP, in last year's fourth quarter it accounted for nearly 30% of the total drop in output.

Monetary Rebound

The early and favorable end of the war means the recession will turn out to be short and shallow. We

Economic Recovery in Second Quarter 1991

(Quarterly percent change, annual rate)



expect the price of West Texas Intermediate crude oil will drop to an average of about $17 a barrel in the second quarter of 1991, the level that existed in the middle of 1990 before Iraq launched its more aggressive position in the oil market and in the Middle East region. We then look for cutbacks in oil production by such countries as Saudi Arabia and a revival in economic growth to push prices to an average of $19 a barrel by the fourth quarter of this year and $20 a barrel in 1992.

The Federal Reserve is expected to continue to be less restrictive in expanding bank reserves and the nation's money supply. An environment of lower oil prices and inflation rates and a moderately stronger dollar removes some of the previous constraints on the Fed's willingness to ease monetary policy. An acceleration of M2 growth to more than 6% in the second quarter will boost nominal GNP growth. Monetary expansion of 4.6% is then assumed for 1992 on a fourth-quarter-to-fourth-quarter basis.

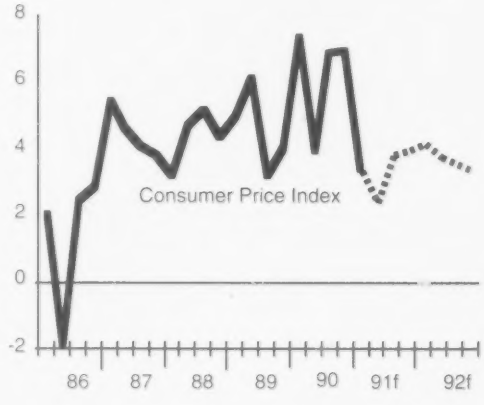
The risk for monetary policy in the near term is that the rebound in economic activity and credit demands could be surprisingly strong, thus rekindling expectations of accelerating inflation. Both after the ending of credit controls during the Iran hostage crisis of 1980 and after the stock market crash of 1987, monetary policymakers found the resiliency of the economy difficult to contain. The Fed initially failed to constrain surging demand in 1980, so the hard landing of 1981-82 become unavoidable after inflation soared to double-digit rates. In the spring of 1988, the Fed was successful in cooling inflation expectations at an early stage, thus avoiding the necessity of a recessionary hangover. Thus, in the early months of the 1991 recovery, the Fed will once again be faced with difficult decisions about the proper degree of stimulus.

Lower Inflation to Help Financial Markets

We look for inflation in terms of consumer prices to average only about 3% in the first half of 1991, as falling oil prices combine with the impact of past monetary restraint to limit wage and price increases throughout the economy. In the second half of the year, inflation should generally average about 4%. We expect inflation to trend below 4% in 1992 as the delayed impact of prior monetary tightness remains effective. The restrictive monetary policy pursued for the past four years will constrain the "core" rate of inflation, while the decline in oil prices will unwind the temporary run-up in consumer prices experienced in the latter half of 1990. Consequently, whereas consumer prices jumped 6.2% in 1990 on a fourth-quarter-to-fourth-quarter basis, they should rise approximately 3.4% in 1991 and 3.8% in 1992.

Inflation Drops Below 4%

(Quarterly percent change, annual rate)

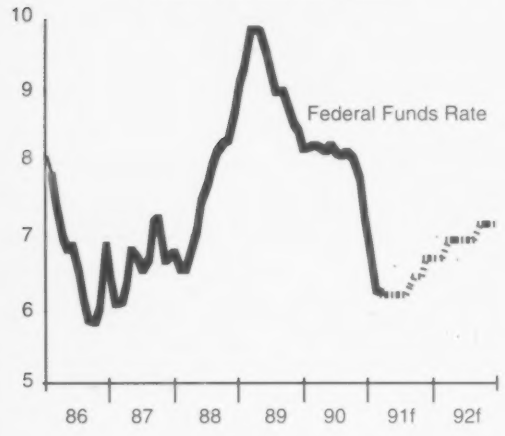


Most short-term interest rates may have already reached the low points for this cycle in early 1991. We expect the federal funds rate to be held at about 6.25% until midyear, down two full percentage points from last July's level. The bank prime rate should fall to 8.5% and remain there for the balance of 1991. As the economy begins to gather momentum later this year, short-term rates will again start to trend higher.

Events in the Middle East have dominated movements in the long-term bond market since last August. The end of the war and lower oil prices and inflation should allow long-term yields to drop below 8% as inflation rates fall. The yield on 30-year Treasury bonds reached 9% last September. In 1992, moderate inflation should cause long-term Treasuries to average about 8.0%. Mortgage rates for 30-year fixed-rate loans should fall to about 9.25% in the second quarter of 1991 and then average close to 9.5% for the remainder of the 1991-92 forecast period.

Short-Term Rates Mirror Economy's Strength

(Monthly averages, percent)



Near-Term Recovery

Consumers and business firms deferred major purchases, hiring, and investments as long as concern about the Middle East persisted. Households that had deferred buying cars, appliances, or homes will now go forward with those purchases. Businesses, which had temporarily shelved investment projects, should implement those plans. Although we expect a decline in first-quarter real GNP, the economy should be moving significantly forward by the second quarter. We expect that growth will average about 2.5% in the final three quarters of 1991 before moderating to slightly above 2% in 1992.

Restoration of previously postponed economic activity will cause the various monthly statistical reports to show sizable improvement. Unemployment will remain high for a several months into the recovery, although slow growth of the labor force will temper the overall rise. We estimate that the civilian jobless rate will reach a peak of about 6.4% in the first part of 1991 and then gradually recede to 5.6% by the end of 1992.

Corporate profits are expected finally to revive modestly as the upturn in sales flows quickly to the bottom line of business firms. Earnings should start to improve by this year's second quarter. For 1991 as a whole, after-tax economic profits are likely to decrease about 2% after dropping more than 7% in 1990. We anticipate a rebound of approximately 11% in 1992.

A general rise in consumer sentiment, higher stock prices, and lower gasoline costs should help sales of autos and light trucks reach 13.4 million in 1991. This level would be down about 3% from last year's total, but costly incentives are likely to be used much less extensively during the current year. We look for sales in 1992 to expand to 14.8 million vehicles.

Real Estate and Construction - How Beleaguered?

The combination of a weakening economy and the Middle East crisis pushed sales of existing single-family homes down 4.3% in 1990 to the lowest level since 1985. Regional differences were pronounced. Sales in the Northeast fell for the fourth year in a row, while activity in the South edged slightly higher. Sales of condominiums and co-ops fell by 9.7% nationally last year.

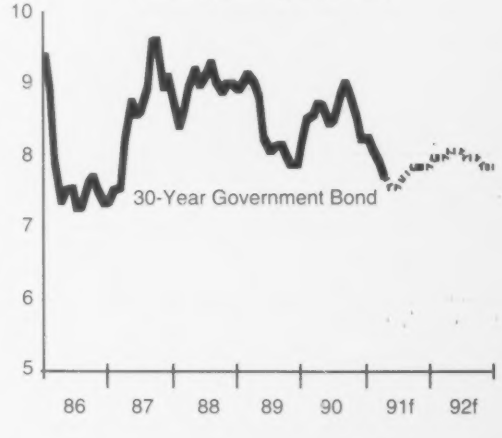
The three states with the largest advances in resales of single-family units, condominiums, and co-ops in 1990 were Idaho (23%), Nevada (21%), and Utah (14%). Massachusetts showed the largest decline with a drop of 25%.

The median national home price increased a modest 2.6% in 1990 to $95,500. Three fourths of the nearly 100 metropolitan areas surveyed by the National Association of Realtors reported price increases on average last year. Many of the areas registering price declines were relatively high priced. By the end of 1990, all the areas with a median price of $150,000 or above had experienced a drop in price from the level existing at the end of 1989, with the exception of Honolulu.

Home mortgage lending continued to expand substantially in 1990, with bank loans up about 15% from the prior year, as of the third quarter. The drop in mortgage rates is likely to spur a sizable amount of refinancing this spring. At the same time, lower

Long-Term Rates Respond to Better Inflation Prospects

(Monthly averages, percent)



FEDERAL DEFICIT: BREAKING THE $300 BILLION BARRIER

The federal budget deficit is likely to reach $310 billion in fiscal 1991 and total another $300 billion in fiscal 1992. These will be largest deficits on record and be substantially higher than last year's $220 billion spending-revenue gap.

Deposit insurance payments, representing primarily costs associated with the S&L debacle, will amount to close to $100 billion this year and more than $90 billion in 1992. While these costs signal a basic flaw in the deposit insurance system, they will have little impact on financial markets or interest rates. Consider what happens when a thrift institution is closed. Funds from current or future taxpayers are transferred to depositors, but those funds are then mostly redeposited in other financial institutions. There is, therefore, little net drain on funds in the financial system.

While deposit insurance comprises nearly one third of the deficit, interest comprises about two thirds. Because the national debt now totals about $3.5 trillion, interest expense amounts to about $200 billion a year.

The ultimate net cost of Operation Desert Storm will depend on how much of the equipment lost is replaced. The marginal cost was held down by the fact that sizable inventories of equipment and war materiel had accumulated prior to the war and that many of the troops were redeployed from existing bases in Europe or the United States. The impact on the deficit will also be limited by pledges of some $50 billion by other countries to offset costs of the war effort. Consequently, the net cost of the Middle East war in fiscal 1991 is likely to be no more than about $15 billion.

Although the recession has adversely affected federal revenues this year, the major deficit problem stems from the spending side. Taxes will amount to about 19.5% of GNP in fiscal 1991, including the impact of various tax increases implemented this year. Spending will equal nearly 25% of total GNP, a level far exceeding the 19% target set just a few years ago at the beginning of the Reagan term. The growth of entitlement and other programs whose benefits, grants, or subsidies are mandated by law has been the major problem. Such programs currently account for about 50% of total federal outlays.

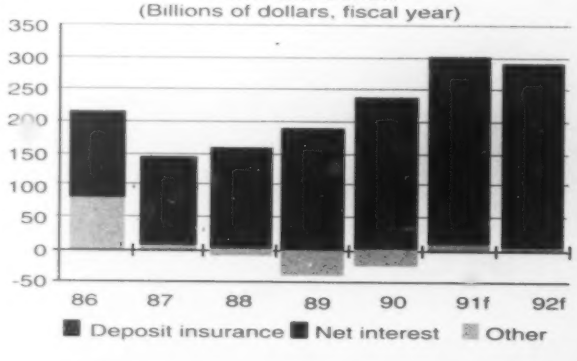
The new budget process hammered out by Congress last fall sets individual spending caps for three parts of the budget: defense, international, and other "discretionary" programs. Entitlement programs are placed on a "pay as you go" basis. Benefits of one program can only be increased if payments under another program are cut or if taxes/fees are raised. Similarly, certain taxes can only be cut if other taxes/fees are raised or if some entitlement or mandatory programs are scaled back. While the new budget process has some promise, it sets no definite limits on the possible expansion of entitlement programs. Moreover, the new process has yet to be tested; significant loopholes are likely to be discovered.

The impact of a $300 billion deficit depends on how it is financed. If the government were to monetize it, that is, purchase debt with newly created money, the result would be higher inflation. With the Federal Reserve reluctant to feed the link between deficits and inflation, the government must borrow directly from the private sector. The potential thereby exists for higher interest rates and "crowding out" of business and household borrowing. This risk can be reduced by the willingness of foreigners to invest in the United States; it is aggravated by our low domestic saving rate.

The federal government recently has been absorbing about two fifths of funds raised in domestic capital markets. Prospects of a stronger dollar later in the year should help sustain a sizable inflow of foreign funds, while domestic saving should rise in the near term. Meanwhile, business borrowing is typically weak in the early stages of recovery as cash flow improves. Consequently, the federal deficit is unlikely to have a significant impact on interest rates and will not lead to a major "crowding out" of household and business borrowers in 1991. A tightening of monetary policy and stronger business credit demands in 1992 could cause the federal deficit to be a larger problem next year.

The Congressional Budget Office has indicated that the federal deficit could fall below $60 billion by fiscal 1995. That forecast is predicated on resumption of faster economic growth, success of the new budget process, and a net inflow of funds for deposit insurance as thrift assets are sold. While there are good reasons to believe that the deficit will be reduced at least moderately in the next few years, the near-term outlook is for a high rate of federal spending and accompanying large budget deficit.

Deposit Insurance and Interest Dominate Deficit
(Billions of dollars, fiscal year)



mortgage rates and a rebound in consumer confidence should spark a recovery in sales activity. Although higher unemployment will place a lid on the real estate market, especially in some locales, potential buyers will respond to lower financing costs and the possibility of a bottoming out of prices.

Partly because the price of new homes often exceeds the price of previously built structures ($122,500 vs. $95,500 in 1990), new-home sales fell much more sharply than resales in 1990. National new-home purchases dropped 18% last year, with double-digit declines in all four major geographic regions. New construction in terms of new housing starts fell 13% to 1.19 million units, the lowest level since 1982. Single-family building dropped 11%, while multi-family starts plunged 20%.

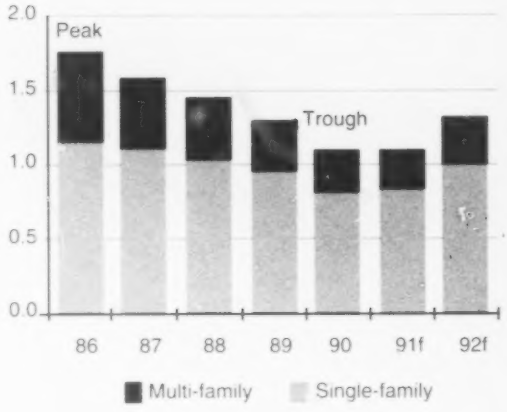
A pickup in sales of both new and existing homes should prompt a gradual recovery in homebuilding in 1991. We expect housing starts to increase about 2% to 1.22 million units in the current year, with the national gain concentrated in the single-family sector. Better-capitalized builders will lead the upturn. Housing activity should improve further in 1992, with starts reaching 1.44 million units. Multi-family construction will begin to benefit from lower vacancy rates and higher rental rates yielding better rates of return.

The nonresidential market continues to grapple with excess capacity. Last year, the value of permits for nonresidential building fell 4%, with weakness in new offices, hotels, and other commercial building only partly offset by an increase in planned spending for alterations and renovation. We expect the value of permits for nonresidential construction to again fall slightly in 1991 before a modest 3% upturn takes place in 1992.

Excess office space is being slowly absorbed. Coldwell Banker Commercial reports a slight easing in the U.S. average office vacancy rate from 20.0% at the end of 1989 to 19.5% at the end of 1990. Recently, vacancy rates have declined in the west and southwest, while still climbing in the east and northeast.

U.S. Housing Starts Begin Upturn

(Millions of units)



Smaller amounts of space coming on line in the next two years should help ease the office market's plight. Coldwell Banker's latest survey indicates that 35 million square feet of new space will be added this year, compared with the addition of 65 million square feet in 1990. The addition of new space is expected to be cut in half again to about 17 million square feet in 1992.

Public construction has been the primary exception to the general recession gripping the building industry during the past year. Public construction of educational facilities, hospitals, streets, highways, rapid transit, and water facilities soared by 11% in 1990. Because many of these projects are funded by bond issues or specially earmarked tax revenues, they are largely insulated from the fiscal squeeze faced by various levels of government in many areas. Public infrastructure work can be expected to remain strong during 1991-92.

FORECAST OF INTEREST RATES

(Quarterly average)

	1990				1991				1992			
	I	II	III	IV	I	II	III	IV	I	II	III	IV
Short-Term	Actual				Forecast							
Fed Funds (Overnight)	8.25	8.24	8.16	7.74	6.47	6.25	6.38	6.67	6.93	7.00	7.09	7.25
Treasury Bills (3-month)[1]	7.76	7.75	7.48	6.99	5.99	5.85	5.94	6.17	6.33	6.50	6.58	6.75
CDs (3-month, secondary)	8.24	8.33	8.04	7.97	6.72	6.38	6.48	6.77	6.93	7.10	7.18	7.35
Eurodollar (3-month)	8.28	8.34	8.05	7.99	6.76	6.39	6.48	6.77	6.93	7.10	7.18	7.35
Prime Rate	10.04	10.00	10.00	10.00	9.17	8.50	8.50	8.50	9.00	9.00	9.00	8.50
Long-Term												
U.S. Government Bonds (30-yr)[2]	8.44	8.65	8.80	8.55	8.08	7.65	7.80	7.90	8.00	8.10	8.00	7.90
Corporate Aaa (Moody's)	9.19	9.40	9.40	9.29	8.90	8.50	8.65	8.73	8.80	8.88	8.75	8.65
Mortgage Rate (Fixed)[3]	10.12	10.34	10.11	9.95	9.50	9.22	9.40	9.50	9.60	9.70	9.60	9.50

(1) Bank discount basis (2) Yields adjusted to constant maturities (3) Contract rates on first mortgages, conventional market

MAJOR ECONOMIC INDICATORS

	QUARTERLY												4th QUARTER					
	1990				1991				1992				% Change		1991	% Change '91/'90	1992	% Change '92/'91
	I	II	III	IV	I	II	III	IV	I	II	III	IV	1990	'90/'89				
	Actual				Forecast				Forecast				Actual				Forecast	
GROSS NATIONAL PRODUCT (Billions of $, annual rate)	5375.4	5443.3	5514.6	5521.3	5565.0	5654.6	5740.3	5823.1	5908.6	5993.9	6078.9	6163.8	5521.3	4.4	5823.1	5.5	6163.8	5.8
% Change, annual rate	6.7	5.1	5.3	0.5	3.2	6.6	6.2	5.9	6.0	5.9	5.8	5.7						
REAL GNP (Billions of 1982 $, a.r.)	4150.6	4155.1	4170.0	4149.5	4130.3	4155.9	4185.8	4209.9	4227.9	4250.2	4273.6	4297.2	4149.5	0.4	4209.9	1.5	4297.2	2.1
% Change, annual rate	1.7	0.4	1.4	-2.0	-1.8	2.5	2.9	2.3	1.7	2.1	2.2	2.2						
REAL FINAL DOMESTIC SALES* (Billions of 1982 $, a.r.)	4195.2	4189.1	4210.5	4191.7	4169.4	4183.0	4205.1	4225.8	4244.0	4264.8	4285.2	4305.3	4191.7	0.6	4225.8	0.8	4305.3	1.9
% Change, annual rate	2.7	-0.6	2.1	-1.8	-2.1	1.3	2.1	2.0	1.7	2.0	1.9	1.9						
REAL CHANGE IN INVENTORIES (Billions of 1982 $, a.r.)	-2.2	9.5	4.7	22.2	-15.0	-4.0	3.0	6.0	7.0	9.0	11.0	13.0	22.2	N/A	6.0	N/A	13.0	N/A
GNP DEFLATOR (1982=100)	129.5	131.0	132.2	133.1	134.7	136.1	137.1	138.3	139.8	141.0	142.2	143.4	133.1	4.0	138.3	3.9	143.4	3.7
% Change, annual rate	4.8	4.7	3.7	2.8	5.0	4.0	3.2	3.5	4.2	3.7	3.5	3.4						
CONSUMER PRICE INDEX (1982-84=100)	128.2	129.4	131.6	133.8	134.9	135.8	137.1	138.4	139.9	141.2	142.4	143.6	133.8	6.3	138.4	3.4	143.6	3.8
% Change, annual rate	7.5	3.8	7.0	6.9	3.4	2.5	3.9	4.0	4.2	3.8	3.6	3.4						
AUTO SALES (Millions, annual rate)	9.8	9.5	9.7	9.0	7.8	9.6	10.0	10.2	10.4	10.2	10.2	10.1	9.5**	4.0	9.4**	-1.1	10.2**	8.6
HOUSING STARTS (Millions, annual rate)	1.45	1.20	1.13	1.05	1.04	1.16	1.30	1.36	1.42	1.43	1.45	1.46	1.19**	-13.3	1.22**	1.7	1.44**	18.4
INDUSTRIAL PRODUCTION (1987=100)	108.3	109.4	110.5	108.2	105.9	106.9	108.3	109.7	110.7	111.5	112.3	113.0	108.2	0.1	109.7	1.4	113.0	3.0
% Change, annual rate	0.7	4.1	4.1	-8.1	-8.2	4.0	5.1	5.3	3.8	3.0	2.9	2.5						
NONFARM PAYROLL EMPLOYMENT (Millions)	109.9	110.5	110.7	110.2	109.7	110.1	110.7	111.1	111.4	111.7	112.1	112.5	110.2	0.9	111.1	0.8	112.5	1.3
UNEMPLOYMENT RATE, ALL WORKERS (Percent)	5.2	5.3	5.5	5.8	6.2	6.1	5.9	5.8	5.8	5.8	5.6	5.5	5.8	N/A	5.8	N/A	5.5	N/A
ECONOMIC PROFITS AFTER TAXES (Billions of $, annual rate)	167.0	173.4	161.6	152.8e	151.0	158.0	163.0	168.0	172.0	175.0	180.0	184.0	163.7**	-7.3	160.0**	-2.3	177.8**	11.1
% Change over year ago	-6.7	-4.0	-9.7	-8.8	-9.6	-8.9	0.9	9.9	13.9	10.8	10.4	9.5						
MONEY SUPPLY M2 (Billions of $, a.r.)	3252.7	3284.4	3308.7	3327.2	3354.4	3408.8	3452.2	3493.8	3535.0	3574.9	3614.5	3653.6	3327.2	3.9	3493.8	5.0	3653.6	4.6
% Change, annual rate	6.3	4.0	3.0	2.3	3.3	6.6	5.2	4.9	4.8	4.6	4.5	4.4						

NOTE: All quarterly series are seasonally adjusted; % change, annual rate calculated from prior quarter; calculations based on unrounded data; a.r. = annual rate; e=estimate. *Excluding Commodity Credit Corp. purchases.

**Annual total. N/A = Not applicable.

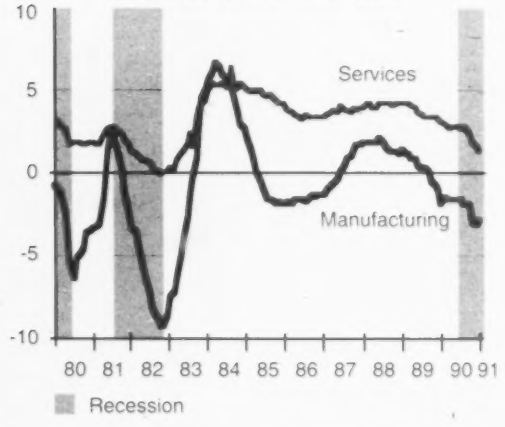
Industry Perspective

Many U.S. industries have been adversely affected by the crisis in the Middle East. Consumer confidence has fallen drastically in recent months, placing increased pressure on industries whose sales are primarily derived from consumer spending.

In the current downturn, manufacturing, which has experienced a 4.6% decline in overall employment since January of 1989, should fare better than in the 1981-82 recession, when employment in this sector declined 8.0% over a twelve month period. Service employment peaked last September after eight years of growth, with declines in wholesale and retail trade, financial services, and real estate since that time. This sector is likely to continue to show small declines in employment during the first quarter of 1991.

Manufacturing Hit by Recession, Services Not Immune

(Monthly percent change in employment from prior year)



The quick resolution of the Middle East war and the subsequent drop in oil prices will benefit industries that are dependent on oil as a production input. Manufacturers of basic organic chemicals (which use oil both as a fuel and as a feedstock), airlines, and other transportation industries should see profits boosted by the reduction in costs due to lower oil prices.

The ability of exports to sustain certain industries through the current downturn may not prove totally effective, despite the weaker dollar. Significant foreign importers of U.S. goods, such as Canada and the U.K., are also in a period of economic decline, which will limit their demand for U.S. exports.

Winners in 1991...

Pharmaceuticals

U.S. drug manufacturers could see sales grow in excess of 10% in 1991, with FDA approval of several new prescription drugs this year. The weaker dollar will also bolster the U.S. pharmaceuticals industry, as the sector derives 30-50% of its ethical (prescription) drug sales from exports. Continued movement away from low-profit, nonprescription drug development and increased expenditures on R & D will improve the strength of this industry over the next several years. Mergers and co-marketing arrangements between U.S. and overseas firms should also help to ensure the long-term success of the pharmaceuticals industry.

Food Manufacturing

Food processing should show another year of positive sales growth in 1991, although not as strong as in recent years. Manufacturers will find it difficult to raise prices this year, with the downturn likely to cause consumers to shift purchases toward more basic, lower-price foods. Overall, retail food prices are likely to increase by only 3-4% in 1991.

Meat and poultry production at near-record levels this year should help economies of scale to be realized in the industry. Further, grain prices are not likely to increase significantly given sizable U.S. spring planting intentions and intense competition in world markets. Exports and joint ventures, especially in Europe, will, however, remain a source of strength for larger food manufacturers.

Machinery

Although planned purchases of some types of machinery may remain on hold during the first half of 1991, sales of other equipment, such as machine tools and materials-handling equipment, should remain stable this year. Refineries and power-generating facilities are responsible for much of the industry's current demand, while considerable backlogs in the civilian aerospace sector should provide an ongoing source of revenues for several years to come.

Despite a decline in machine tool orders in January, lower interest rates and the return of confidence brought about by the end of the Middle East war should act to spur business investment and orders for new machinery. Further gains in exports due to the continued weakness of the dollar should also enhance the industry's performance this year. In 1990, the U.S. generated some $1 billion in net exports (exports minus imports) of nonelectrical machinery.

Health Care

The health care industry should continue to see growth in employment and sales this year despite a general economic downturn. Individuals, uncertain about job security, may opt for elective surgical procedures while they are still covered under employer health plans. Continued emphasis by Congress on limiting medicare spending will cause health

care providers to attempt to switch costs to private payers. This effort may not be entirely successful, given the increased focus on "managed-care" by corporations that are desperately seeking relief from spiraling health care costs.

The outlook for private hospitals this year is somewhat bleaker than that for HMOs (Health Maintenance Organizations) and PPOs (Preferred Provider Organizations). Falling occupancy rates and increased competition for managed-care contracts will act to further reduce the already slimming profit margins of hospitals. Medical-supply companies should perform fairly well in 1991, due to a stable demand for their products, thin but adequate inventories, and the introduction of innovative products and services.

Other industries likely to do well this year include: manufacturers of intermediate and specialty chemical products; computer manufacturers (notebook PCs, laptops, and mainframes); PC software producers; and telecommunications.

. . . And Losers

Retail Trade

Before the rapid fall in consumer confidence brought on by recent events in the Middle East, the retail industry was plagued by other problems. Overcapacity and weakening demand brought on by slower growth in real disposable income, and a more than doubling of consumer debt since 1980 have adversely affected retailers.

Consumer anxiety about the war and the economy has further dampened industry revenues, with sales this year likely to grow by only 3%. Sales should pick up again in 1992, growing by roughly 5% with the return of consumer confidence and a recovering economy. Mail-order retailers will also see an erosion of earnings this year, as postal and small package shipping rates increase some 15-30%. As the industry continues to consolidate, warehouse clubs, niche retailers, and other low-price, mass-merchandisers will gain market share from more traditional retail firms.

Autos

Automobile manufacturers have seen demand fall off drastically in the last few months. Plummeting consumer confidence and tighter credit have caused a sharp decrease in durable goods spending; auto sales for the first month of this year fell by 25% from a year ago.

Faced with declining dealer orders, many manufacturers have reduced 1991 production plans to levels not seen since the last recession. The ending of hostilities in the Middle East could cause auto sales to pickup somewhat as consumer confidence is restored. Still, sales of automobiles and light trucks this year are expected to fall by approximately 3%.

U.S. manufacturers are likely to maintain their current market shares despite the downturn as increased output of domestically-built foreign cars is offset by a decline in imports. Industry sales should recover again in 1992, growing by roughly 10% as the economy regains strength.

Airlines

The recent fall in oil prices has reduced the burden of higher jet fuel costs for aircarriers. The war, however, has increased the threat of terrorism, causing international air travel to be curtailed sharply and imposing higher security and insurance costs on the industry. Add to these factors the drop-off in traffic associated with the slowdown in the economy and 1991 looks to be a dismal year for the industry.

The war in the Middle East only accelerated the process of consolidation that was already underway in this industry. Eastern, which was operating under Chapter 11 protection, has since been grounded, its assets sold to pay off creditors. Pan Am and Continental are currently operating under bankruptcy court protection. Stronger carriers such as Delta, United, and American should be able to expand operations and improve market shares by acquiring the assets and routes of weaker, cash-starved airlines.

Forest Products

Lumber and paper producers should have a difficult year in 1991. The continuing decline in housing starts and lack of new building in many areas have caused lumber prices to collapse. After falling some 35% in 1990, profits for the largest companies in the industry may fall another 10-15% this year.

Current supply conditions for pulp worldwide are likely to lead to a drop in the prices of most types of paper this year. Despite the fact that demand for paper products is expected to remain flat in the near future, industry capacity, already in surplus, is expected to grow another 4% before 1992, according to the American Paper Institute.

The U.S. forest-products industry will be able to compete more effectively with its rivals in Canada and Scandinavia in 1991 as the foreign-exchange value of the dollar makes U.S. pulp and paper prices relatively more attractive. Even with the falling dollar, however, exports of forest products may not be as strong this year as they were in 1990 because of weakening demand overseas.

Among other industries likely to bear the brunt of the economic slump this year are: steel and primary metals producers; manufacturers of furniture and appliances; residential and nonresidential construction; hotels; and real estate.

Financial Institutions

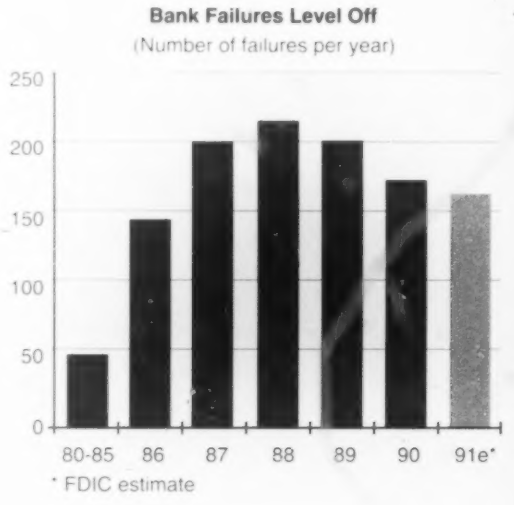
Banking Reform

The Bush Administration has placed banking reform at the top of its domestic policy agenda for 1991. Conceivably, this means that some of the laws governing the banking industry, dating back to the 1930s, are likely to be changed this year in a manner that would ultimately enhance the stability and performance of the nation's financial system. To accomplish this, the Treasury released in February a wide-ranging set of reform proposals, which will be debated in Congress for several months. The reform plan would: (a) allow banks to establish *branches* across state lines, (b) limit the coverage of federal deposit insurance, (c) expand the powers of bank-holding companies to engage in securities and insurance activities, (d) permit industrial firms to own banks, and (e) restructure and redistribute the power to regulate banks.

There seems to be more public and congressional support for comprehensive bank reform this year than in any previous year since Congress passed the last omnibus financial bill in 1980. This support reflects the legacy of the thrift crisis and concern that bank failures could escalate (including the failure of one large bank), draining the Bank Insurance Fund of its dwindling reserves. Another factor is the growing awareness in Congress that America's largest banks are no longer dominant in global banking markets; instead, they have been surpassed by European and Japanese banks—partly because of our heavy burden of restrictive banking laws and regulations.

Concerns about a higher incidence of bank failures are legitimate. The number of bank failures peaked in 1988 at 221, having moved up from an annual average of 52 in the first half of the 1980s. The number of failures declined in 1989 (206) and in 1990 (180), but the largest bank failure ever, Bank of New England, was announced in the first week of 1991. Subsequently, numerous estimates have been published regarding the expected number of failures in 1991-92, all of which contain assumptions about the length and depth of the recession. The official estimate of the Federal Deposit Insurance Corporation (FDIC) of failures in 1991 is 170 to 200—and this is likely based on a short-war assumption. If only a small share of such failures involve banks of fairly large deposit size, FDIC reserves could be depleted.

The Treasury's proposals for reforming deposit insurance contain the following features: (a) Depositors would be limited, after two years, to coverage of $100,000 per institution for checking and savings accounts and $100,000 coverage for retirement accounts; (b) After five years, the foregoing limitations on coverage would apply to a *total* of $100,000 for savings accounts and $100,000 for retirement accounts; (c) Brokered accounts would no longer be covered by insurance; and (d) Premiums charged banks would be risk-based, depending on bank capital levels. The first two features of the plan outlined above are likely to prove quite contentious in Congress. Failure to reduce the maximum coverage of government insurance from the lofty $100,000 level needs to be justified. At this level, government insurance protects more than the small depositor at the expense of exposing the general universe of taxpayers.



In terms of the likely outcome of bank reform in 1991, interstate branching has the best prospects for passage by Congress this year. The urgency to reform the deposit insurance system is the only other measure that ranks as high as interstate branching. Expanded powers, regulatory restructuring, and mixing commerce with finance have slimmer chances of approval in the current environment. Interstate branching would quicken the pace of consolidation in the banking industry; there are more than 12,000 banks in the United States largely because of the restriction against interstate branching and severe limitations on nationwide banking. By achieving greater operational efficiency and economies of scale, the banking industry could save as much as $15 billion over a five-year period (Treasury estimate). This would be a significant amount, given that after-tax earnings of the industry for the first nine months of 1990 equaled a total of $15.5 billion.

Credit Quality Problems

The banking industry's earnings performance has been impaired by credit quality problems in 1989 and 1990, especially in real estate portfolios. The outlook for bank performance in 1991-92 will be influenced significantly by developments in loan quality. The

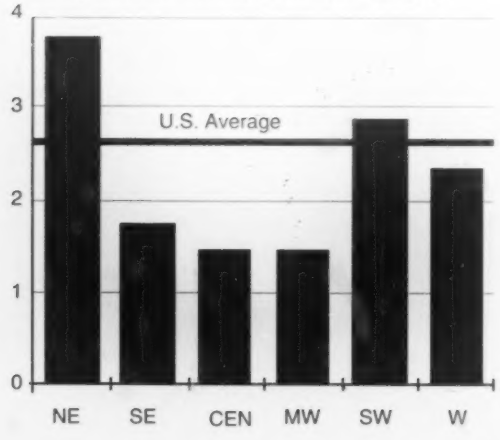
latest industry figures, as of September 30, 1990, show that nonperforming loans (noncurrent loans and leases plus "other real estate") were 2.65% of assets. This represents a sizable increase from 2.14% in 1988 and 2.28% in 1989, with the ratio at only 1.87% as recently as 1985.

A breakdown of the latest figures on nonperforming loans by bank size is quite revealing as to the segment of the industry most affected. For banks with assets greater than $10 billion, the ratio was the highest, 3.38%; it was slightly below the industry average for banks with assets of $1-10 billion. For the smallest banks (less than $100 million in assets), the nonperforming loan ratio was a less burdensome problem, 1.73%, and slightly higher (1.87%) for banks with assets of $100 million to $1 billion. The relatively greater concentration of credit quality problems in larger banks has resulted in predictions by some that heavy loan losses could cause serious difficulties for one or more of the major banks in 1991.

A comparison of nonperforming loans by region indicates a high degree of variation, with no surprises as to which areas of the nation have the most troubled banks. As of September 30, 1990, the nonperforming-loan ratio was highest in the Northeast (the New England states, New York, New Jersey, Pennsylvania, Delaware, Maryland, and the District of Columbia), 3.73%, compared with the national average of 2.65%. Overbuilding, falling property values, and a slumping economy have increased the vulnerability of the region's financial institutions. As of last year, the ratio was also still high in the Southwest (Texas, Oklahoma, Louisiana, New Mexico, and Arkansas), at 2.89%—reflecting the lingering effects of the oil-related slump of the mid 1980s and the devastating impact on real estate markets. In the West (from the Rockies to the Pacific), the nonperforming-loan ratio was 2.34%, below the national average. This region's relatively high ratio was heavily influenced by Arizona's real estate troubles. Other regions, the Midwest, the Southeast, and Central (Great Lakes) had relatively low ratios of nonperforming loans.

Nonperforming Loans Vary By Region

(Percent of assets; September 30, 1990)



The wide geographic variation in credit quality that banks have experienced constitutes powerful evidence favoring interstate branching. Such branching would allow greater diversification of bank assets across industry and regional lines and enhance the risk management strategies of banks.

Impact of an End to the War

The end of the war in the Middle East is expected to have a positive impact on financial institutions. Improvement in consumer confidence will stimulate some growth in installment and mortgage lending. For both banks and savings and loans, the excess inventory of housing will be absorbed more quickly, thus helping to reverse the recent rise in nonperforming real-estate loans.

Lower mortgage interest rates are now expected for most of 1991, which should boost home sales and improve the financial position of builders and developers of residential property. The credit quality problems of banks are likely, as a result, to improve in the second half of 1991 and into 1992.

The task of the Resolution Trust Corporation—closing failed thrifts and selling assets—will be made less difficult by a short war. More buyers of failed thrifts will become available, and real estate assets will be less difficult to dispose of with a major uncertainty removed from the environment. For healthy savings institutions, a short and shallow recession will only modestly impair their operating performance—still tied to conditions in real estate markets, as thrifts must allocate at least 70% of their assets to real-estate-related activities.

Early recovery from recession will mean fewer bank failures, closer to the lower end of the FDIC's estimate—170 in 1991. Recent private estimates of the number of banks that could fail in 1991-92, based on an assumption of a long war and a protracted recession, would be given little attention. Currently, such very high estimates seem alarmist.

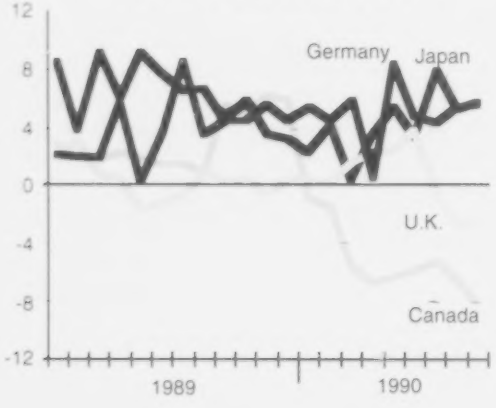
The International Economy

Slowdown In Industrial Countries

Evidence of slower economic growth has appeared in most of the major industrial countries outside the United States. The United Kingdom and Canada have been experiencing recessions since the middle of 1990, and growth in continental Europe has slowed. Although Japanese growth remains relatively robust, it is less so than earlier. As indicated in the accompanying graph, industrial production has experienced a significant slowdown in most of the largest industrial economies, but remains strong in the two largest.

Industrial Production in Japan and Germany Still Strong

(Percent change from prior year)



The slowdown in growth was exacerbated in early 1991 by the outbreak of the Middle East war. As in the United States, investment decisions and consumer spending were postponed. In addition, monetary policy in Germany and, therefore, the other member countries of the European Monetary System has been tightened further. Although inflation in Germany is still expected to be in the 3.0-3.5% range, short-term interest rates have risen to the neighborhood of 10%. The very high real interest rates that prevail in Europe are likely to remain for most of the first half of the year, braking investment. Thus, for the EC member countries, real economic growth in 1991 is expected to be the lowest since 1983, with an overall EC growth rate of about 1.5%.

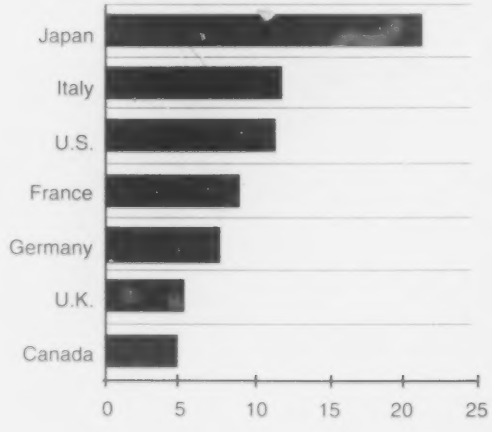
The Japanese economy is also decelerating following its strong expansion of 6% in 1990. Most of that growth took place during the first half of the year, and slower growth has been evident recently. Monetary policy has been progressively tightened to prevent a rise in inflation from its previously low levels. Reflecting mainly higher oil prices, consumer prices during the fourth quarter of 1990 were 4% above their year-earlier level, although the "core" rate of inflation remains considerably lower. Some difficulties in Japanese real estate and banking markets will also be factors in the slower growth expected this year. Nevertheless, the Japanese economy should still expand at a rate above 3% both this year and next.

In sum, growth in the industrial countries outside the United States will be slower overall this year. Japan and Germany will grow more rapidly than the other major countries, however. With these two countries being the principal "locomotives" of growth, how vulnerable is the world economy to a full-fledged downturn? Is there a risk that Japan and/or Germany will join the United States in recession? Drops in the Japanese stock market and in real estate prices could result in more serious financial difficulties than now foreseen, causing confidence to drop. At the same time, exports no longer provide a source of growth for Japan. In Germany, growth appears more solidly founded, with considerable impetus from the unification of the two parts of the country. Nevertheless, reduced export growth, restrictive monetary policy, and the reduction in economic activity in the eastern part of the country present risks.

Higher economic growth in Japan and Germany than elsewhere, together with strong currencies in both countries, has implications for global capital flows. The current-account surpluses of both Japan and Germany declined in 1990. Japan's surplus fell by more than a third to about $36 billion, while Germany's fell only slightly to about $50 billion. Higher oil prices in the first half of 1991 are particularly negative for the Japanese balance of payments, since Japan's trade balance is more dependent on

Japan Has Largest Fuel Import Share

(Fuel imports as percent of total imports, 1989)



imported fuels than the corresponding balances of other industrial countries.

Both countries' current-account surpluses are expected to fall further in 1991, despite lower oil prices, and Germany's could fall quite substantially as domestic investment rises. As a result, these two countries, which have the world's largest holdings of foreign assets, will be less dominant in global financial markets during the coming two years.

World Trade Growth Decelerating

The slowdown in the growth of world trade volume (adjusted for inflation) in 1990 reflected the lower collective industrial-country real economic growth, led by the U.S. recession beginning in the second half of the year. The 1990 industrial-country growth rate was only about half that for 1987. With industrial-country growth of less than 1.0-1.5% expected in 1991—the third consecutive year of decreasing growth—world trade will be increasingly lethargic. As the world economy shakes off the 1991 doldrums, however, we look for a rebound in 1992. We anticipate that the growth of world trade volume will about double in 1992.

WORLD TRADE
(Imports, percent change)

	1988	1989	1990e	1991f	1992f
Volume	**8.6**	**6.8**	**1.2**	**1.8**	**3.7**
Price	4.9	1.2	7.5	-4.5	5.0
Nominal	**13.9**	**7.9**	**8.8**	**-2.8**	**8.9**

In 1990, the increase in import prices resulted from countries' previous domestic economic policies and from the sharp rise in oil prices in the months immediately following the Iraqi invasion of Kuwait. Non-energy commodity prices, however, decreased. In 1991, we expect that oil prices will decline 20-22% on average and that non-energy commodity prices will continue to fall, as will domestic inflation rates generally. It is clear that the large price increase in 1990 is partially mirrored in the price decrease in 1991. The underlying inflation rate is only 1.5-2.0% annually for 1990-91. In 1992, we look for oil prices to rise a modest 3-4% and for prices of other commodities to rise also.

We anticipate that world trade in nominal or inflation unadjusted terms will contract this year, following 1990's unexpectedly strong increase. This contraction would be the first since 1983. In 1992, nominal world trade will expand once again.

Mixed Picture For Developing Economies

Developing countries that do not export oil have experienced a difficult environment recently. Recession in North America, which is a major export market for East Asian and Latin American developing countries, will lead to slower export growth. At the same time, imports were inflated by higher oil prices. This combination was particularly adverse for the newly industrialized economies of East Asia, since the United States is their largest customer and they must import all their oil. Nevertheless, these countries have the financial strength to withstand these difficulties.

Other countries that have high levels of external debt and that must import energy were more vulnerable. In particular, Brazil and the Philippines can be cited, the latter's financial difficulties being exacerbated by the reduction in remittances from workers in the Middle East. A return to lower oil prices and reconstruction activity in the Middle East should provide some relief as the year progresses.

By contrast, developing countries that export oil received a windfall from the period of higher prices. Indonesia, Mexico, and Venezuela are perhaps the foremost examples, although there are numerous others. All three of these countries had undergone significant policy reforms prior to the oil windfall, and thus reaped a double benefit. Both Mexico and Venezuela have established contingency funds in which they are depositing part of their windfall revenues. These funds will be used when oil prices inevitably fall once again to cushion any adverse effects on both government revenues and capital flows. Part of Indonesia's extra oil revenues may be used to reduce external debt.

Declining Trade Deficit Reflects Contracting U.S. Economy

The differential between U.S. export and import growth rates remains marked, as the net-export sector of the U.S. economy thrives, resulting in another year of decline for the trade deficit in 1991. With the recession, U.S. import growth is being slashed, and the expected 20-22% decline in oil prices this year will lower import growth further. We expect a meager 1.5% import growth for the year. Export growth will slow, but by a lesser amount, as the economic expansion abroad loses steam.

U.S. CURRENT ACCOUNT
(Billions of dollars)

	1988	1989	1990e	1991f	1992f
Trade balance	**-127.0**	**-114.9**	**-108.7**	**-92.8**	**-95.7**
Exports	320.3	360.5	389.3	**412.6**	**441.5**
Imports	-447.3	-475.3	-498.0	**-505.4**	**-537.3**
Services balance	**13.1**	**19.6**	**25.4**	**18.5**	**11.9**
Service exports	213.1	242.7	258.3	**265.2**	**278.2**
Service imports	-200.0	-223.2	-232.9	**-246.8**	**-266.2**
Transfers balance	**-15.0**	**-14.7**	**-16.6**	**-4.2**	**-17.3**
Official	-10.7	-11.0	-12.7	**0.0**	**-13.0**
Private	-4.3	-3.8	-4.0	**-4.2**	**-4.3**
Current-account balance	**-128.9**	**-110.0**	**-99.9**	**-78.5**	**-101.1**

A major question for the U.S. current account is the services surplus, which is estimated to have risen in 1990. With large current-account deficits year after year, however, the net outflow of earnings on the U.S. negative net-investment position should rise. For 1991-92, we expect that the services surplus will trend downward. We believe that the war in the Gulf will cause the deficit on net official transfers to decrease in 1991. The approximate size of the net outflow remains unclear at this time. "Pledged contributions" from other countries supporting the allied effort in the Gulf are substantial, but dates of payment are unknown and actual payments uncertain. We are assuming sufficient payments to at least eliminate the official "outflow" of 1990 in 1991.

For 1992, we anticipate a small increase in the trade deficit as U.S. economic expansion increases noticeably from the 1990 level. The lagged effects of the U.S. recession abroad and the effects of tight monetary policy for at least part of 1990 and 1991 will restrain other economies' expansion, keeping the demand for U.S. exports lower than otherwise. The current-account deficits for 1990-92 would average the equivalent of 1.6% of GNP, a substantial decline from levels during the mid 1980s.

Dollar to Weaken Initially, then Strengthen

In recent months, the foreign-exchange markets have traded the dollar on the basis of two main factors: economic fundamentals and the Middle East crisis. Immediately after the Iraqi invasion of Kuwait on August 2, the dollar appreciated momentarily, reflecting the demand for a "safe haven" currency. When it became clear after the commencement of the Allied offensive on January 16 that it was unlikely Iraq would be able to expand the geographical scope of the war, the dollar's "safe haven" appeal waned substantially from an already eroded position.

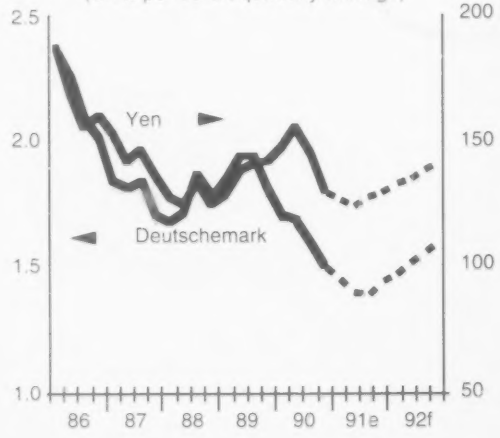
Currently, comparative economic conditions dominate in determining the dollar's value on the foreign-exchange market. With the onset of the U.S. recession in the second half of 1990, the dollar has generally depreciated against other currencies. During the fourth quarter of 1990, the dollar declined 5.6% against the deutschemark (and by similar percentages against other continental currencies) and 9.7% against the yen. In January 1991, the dollar's descent against the mark increased, and the dollar set new post-World-War-II lows against that currency in February.

In both Germany and Japan, the central banks have been waging a monetary war against potential inflation pressures. In Germany, these pressures resulted from unification; in Japan, from double-digit money-supply growth rates. Each country's pursuit of a tighter monetary policy has resulted in higher nominal and real interest rates. Simultaneously, U.S. interest rates have trended downward, as the Federal Reserve has begun aggressively to combatting the recession. The widening of interest-rate differentials between the United States and elsewhere led to the dollar's decline.

In coming months, we look for the dollar to depreciate very modestly from current levels. We believe that Fed policy will result in only small declines in short-term interest rates from existing levels but that long-term rates will decline another 50-55 basis points. During the second quarter, we look for the dollar to bottom in the ¥125-130 region, and against the mark at DM1.43-1.45. We expect that the dollar will begin to strengthen before U.S. interest rates actually start to rise at mid year. By the fourth quarter of 1991, we believe the dollar will appreciate about 2.3% against the yen and 2.1% against the mark. We look for the dollar to strengthen 8.5-9.0% against the yen and the mark from the fourth quarter of 1991 and the fourth quarter of 1992. The appreciation of the dollar from the second quarter of 1991 on reflects improving U.S economic fundamentals—stronger real growth, lower inflation, and a secular decline in the trade deficit, given net-export growth, from levels during the mid- to-late-1980s.

Dollar Appreciates After Mid-1991

(Units per dollar, quarterly average)



The value of the dollar against continental currencies other than the mark may change by different percentages in 1991 as a realignment within the EMS is likely. The recent increase in German interest rates is not a desirable policy for several other European countries, but if they lower their rates, they will not be able to maintain their currencies within the specified band. The pound sterling is already bouncing along the bottom of its band against the mark, for example.

First Interstate Territory

For the second consecutive year, employment and income growth in the 19 states where First Interstate has affiliates or franchise banks exceeded the U.S. average in 1990. We expect this pattern to continue in 1991 and 1992. All Territory states, however, will post slower job growth in 1991 compared with last year before improving in 1992.

Pacific Northwest—Still Solid

The Pacific Northwest (Alaska, Idaho, Oregon, and Washington) will continue to outpace both the rest of FI Territory and the nation during the next two years. Our forecast is for employment gains of 2.0% in 1991 and 3.1% in 1992. Although below the rapid increases of 4-5% in the past three years, these projected growth rates will compare favorably with the meager 0.1% average rise projected for the nation in 1991 and gain of 1.4% in 1992.

Energy exploration and development and tourism should bolster Alaska's economy during the next two years. A gradual recovery in the housing industry will begin to help the lumber and wood products industry in the Pacific Northwest, but mainly in 1992. Further population growth, gains in exports, and record commercial aircraft backlogs will be pluses for the region.

Rocky Mountains—Gradually Recovering

The Rocky Mountain states (Colorado, Montana, New Mexico, Utah, and Wyoming) will see composite employment growth ease from last year's 2.4% to 1.7% in 1991 before it improves to 2.5% in 1992. Oil prices will support a moderate amount of drilling for oil and natural gas and help firms supplying energy equipment and services. Environment regulations will boost demand for the region's low-sulfur coal.

Tourism, increasingly important to the region, should recover substantially in coming months. The region is slowly reducing its oversupply of office and other commercial space. Denver's office vacancy rate, for example, has dropped from about 25% two years ago to 22% at the end of 1990. The region, nevertheless, remains vulnerable to swings in energy and other commodity prices.

Southern Tier—Texas Advances

The Southern Tier states (Louisiana, Oklahoma, and Texas) are likely to see their growth rate slow from last year's 1.7% to 1.1% in 1991. We look for a 2.1% employment gain in 1992.

The Texas economy has diversified away from its oil dependence, and employment growth has been 2% during each of the past three years. Although growth will slip well below 2% in 1991 along with most other states in the nation, a sizable recovery of about 2.4% is expected in 1992. Louisiana and Oklahoma have realized some benefit from higher oil prices, but both states are likely to see minimal gains in employment this year before a stronger national economy allows them to advance in 1992.

North Central—Farm Sector Steady

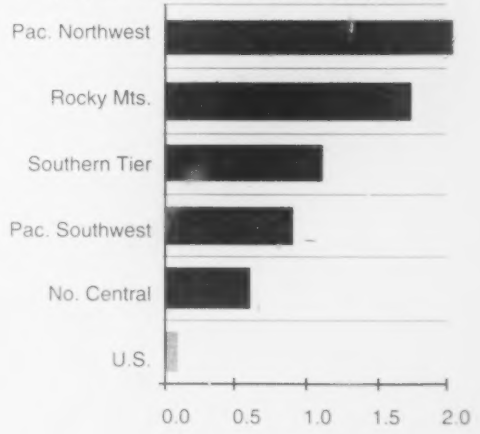
The North Central states (Iowa, North and South Dakota) can be expected to show only a modest gain in nonfarm jobs (0.6%) in 1991, but then revive with a 1.6% increase in 1992. Better prospects for the manufacturing sector will help the region. Although wheat prices are down this year, stable or slightly higher prices for corn and livestock products should help support farm incomes in 1991. Farmers will begin to take advantage of greater flexibility under the new farm bill to diversify their crops, but feed grain supplies could again expand in the coming year.

Pacific Southwest—Temporary Setback

The Pacific Southwest (Arizona, California, Hawaii, and Nevada) had been one of the strongest performing regions in the nation, although growth in each of the four states has proceeded at times at unsustainable rates. We expect nonfarm payrolls to increase just 0.9% in 1991 after gains of 3-4% in each of the past three years.

The Pacific Southwest should outperform the country again by 1992, with a 2.0% gain in nonfarm payrolls. Nevada will adjust to a slowing of its recent boom generated by the rapid construction of new hotels, casinos, and other facilities. The state's job growth is still likely to be in the 4-5% range in the near term. California and Arizona should both post moderate job and population gains in 1992, which will help the real estate markets in both states.

Strongest 1991 Growth in the Pacific Northwest
(Percent change in nonfarm employment)



NONFARM PAYROLL EMPLOYMENT

	1989		1990		1991f		1992f	
	Thousands	% Change	Thousands	% Change	Thousands	% Change	Thousands	% Change
Alaska	**227**	**6.4**	**233**	**2.6**	**238**	**1.9**	**243**	**2.1**
Arizona	1,457	2.7	1,497	2.7	1,533	2.4	1,592	3.8
California	**12,585**	**4.0**	**12,928**	**2.7**	**12,993**	**0.5**	**13,214**	**1.7**
Colorado	1,472	2.5	1,501	2.0	1,525	1.6	1,563	2.5
Hawaii	**505**	**5.6**	**519**	**2.9**	**528**	**1.7**	**540**	**2.2**
Idaho	367	5.4	386	5.0	396	2.5	408	3.2
Iowa	**1,200**	**3.8**	**1,225**	**2.1**	**1,231**	**0.5**	**1,250**	**1.5**
Louisiana	1,516	0.3	1,531	1.0	1,538	0.5	1,557	1.2
Montana	**291**	**2.7**	**296**	**1.9**	**298**	**0.8**	**303**	**1.5**
Nevada	582	8.3	625	7.3	653	4.5	683	4.7
New Mexico	**561**	**2.4**	**569**	**1.4**	**570**	**0.3**	**579**	**1.5**
North Dakota	260	1.4	266	2.1	268	0.8	273	1.9
Oklahoma	**1,154**	**2.0**	**1,167**	**1.1**	**1,173**	**0.5**	**1,189**	**1.4**
Oregon	1,207	4.4	1,247	3.3	1,262	1.2	1,313	4.1
South Dakota	**275**	**3.3**	**281**	**2.1**	**283**	**0.8**	**289**	**2.0**
Texas	6,810	2.0	6,940	1.9	7,031	1.3	7,199	2.4
Utah	**691**	**4.7**	**723**	**4.7**	**749**	**3.5**	**777**	**3.8**
Washington	2,045	5.3	2,139	4.6	2,190	2.4	2,249	2.7
Wyoming	**194**	**2.4**	**196**	**1.2**	**197**	**0.6**	**200**	**1.4**
FI Territory	33,398	3.4	34,267	2.6	34,654	1.1	35,420	2.2
U.S.	**108,413**	**2.7**	**110,328**	**1.8**	**110,393**	**0.1**	**111,917**	**1.4**

PERSONAL INCOME

	1989		1990e		1991f		1992f	
	$ Billions	% Change	$ Billions	% Change	$ Billions	% Change	$ Billions	% Change
Alaska	**11.4**	**13.0**	**12.1**	**5.8**	**12.8**	**6.4**	**13.7**	**6.6**
Arizona	56.2	7.6	60.0	6.8	64.3	7.2	69.3	7.8
California	**579.2**	**8.1**	**622.5**	**7.5**	**658.0**	**5.7**	**700.1**	**6.4**
Colorado	58.2	7.1	61.9	6.3	65.8	6.3	70.2	6.7
Hawaii	**20.5**	**11.3**	**22.3**	**8.6**	**23.9**	**7.1**	**25.7**	**7.6**
Idaho	13.9	9.6	15.1	8.7	16.1	6.8	17.2	6.9
Iowa	**44.0**	**8.5**	**46.7**	**6.3**	**49.0**	**4.9**	**51.8**	**5.6**
Louisiana	56.6	5.0	60.3	6.5	63.5	5.3	66.9	5.4
Montana	**11.3**	**9.5**	**11.9**	**5.0**	**12.5**	**5.1**	**13.2**	**5.5**
Nevada	21.4	13.7	23.5	10.0	25.5	8.2	27.7	8.9
New Mexico	**20.1**	**7.2**	**21.3**	**6.1**	**22.3**	**4.8**	**23.5**	**5.3**
North Dakota	9.0	8.7	9.2	3.0	9.7	4.8	10.2	5.6
Oklahoma	**45.6**	**6.1**	**48.5**	**6.2**	**50.9**	**5.0**	**53.5**	**5.2**
Oregon	44.9	9.5	48.4	7.9	51.3	5.9	55.2	7.7
South Dakota	**9.8**	**8.8**	**10.4**	**6.2**	**10.9**	**4.6**	**11.5**	**5.5**
Texas	266.8	7.4	285.2	6.9	303.5	6.4	325.3	7.2
Utah	**22.3**	**8.0**	**24.0**	**7.6**	**25.8**	**7.5**	**27.9**	**7.9**
Washington	84.0	10.4	91.6	9.0	98.1	7.1	105.1	7.2
Wyoming	**6.9**	**4.6**	**7.3**	**6.0**	**7.6**	**4.6**	**8.0**	**5.4**
FI Territory	1,382.2	8.1	1,482.3	7.2	1,571.5	6.0	1,676.2	6.7
U.S.	**4,368.1**	**7.6**	**4,628.5**	**6.0**	**4,864.5**	**5.1**	**5,138.4**	**5.6**

Note: Calculations based on unrounded data.

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Alaska
First Interstate Bank of Alaska, N.A.

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First Interstate Bank of California
First Interstate Bank, Limited

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Montana
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Nevada
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Oregon
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First Interstate Bank of Texas, N.A.

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First Interstate Bank of South Fort Collins

Hawaii
First Interstate Bank of Hawaii

Iowa
First Interstate Bank of Iowa

Louisiana
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Wyoming
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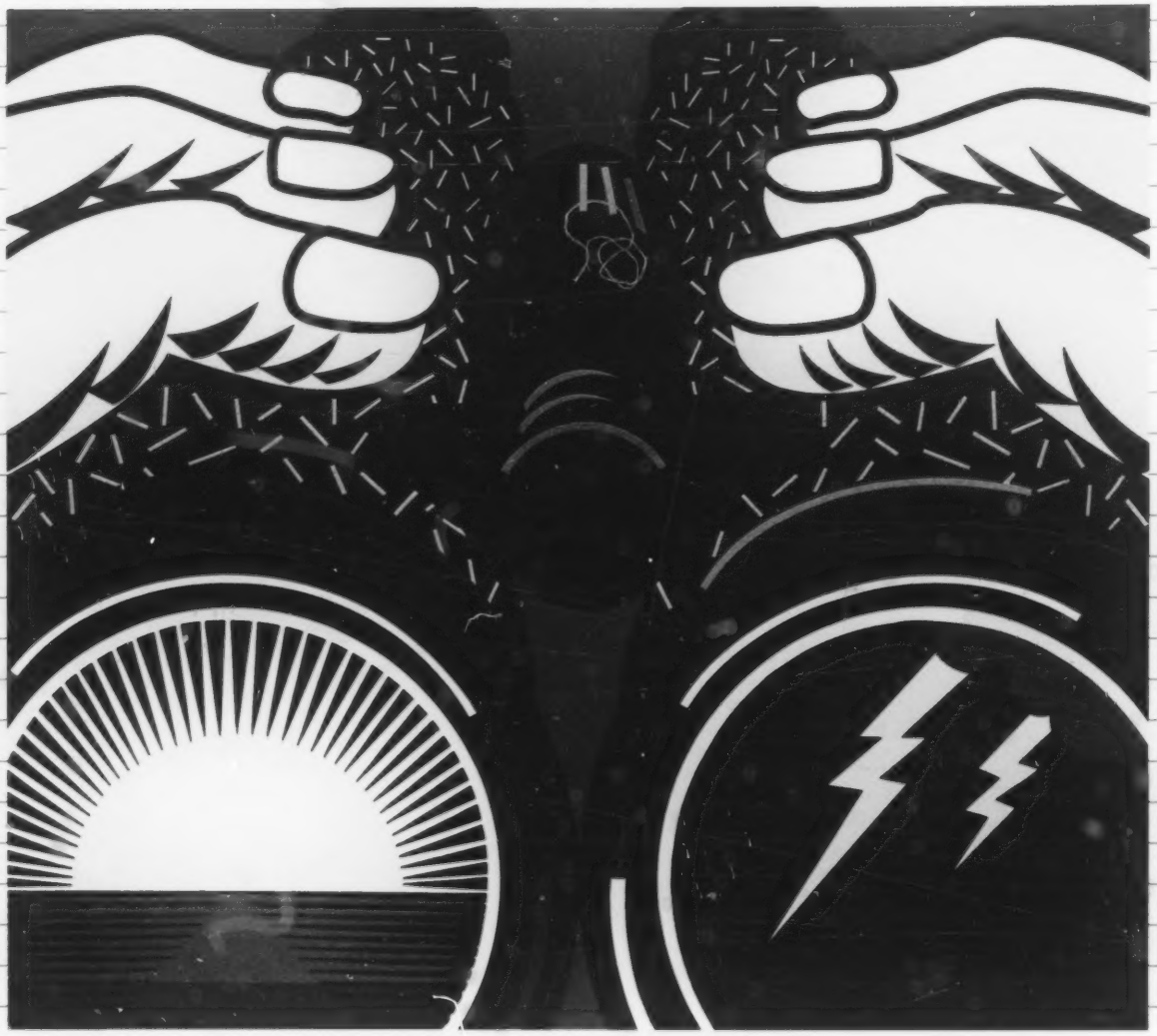
FORECAST
1991-1992



UPDATE

June 1991

Including Five-Year Projections

First Interstate Territory Edition

First Interstate Bancorp

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Overview

Initial conditions for expansion are the most favorable since the early 1960s. As the national economy completes the transition from contraction to growth, the robustness and durability of the recovery from recent recession are being debated. In this annual review of the five-year economic outlook, we focus on the contrasts with the early 1980s and the prospects for a sustainable, though not vigorous, expansion.

Durability of Expansions. The record long expansion following the 1960-61 recession ended in the inflationary excesses of the Vietnam War and Great Society Programs. The periods of economic expansion after the recessions of 1970, 1974-75, and 1981-82 each ended with an "oil shock." Sharply higher international oil prices caused temporary accelerations in inflation and upward spikes in world interest rates. Contractionary monetary policies often steepened and prolonged the recessions.

Expansions do not die of "old age" or a lack of stimulus. The expansion of the 1990s may well endure into the next century. It ultimately will end—possibly as a result of yet another Middle-East "oil shock." However, such developments are impossible to anticipate in the early stages of recovery. Our medium-term outlook is for an uninterrupted expansion through 1996.

The Starting Gates. The 1990 "oil shock" was considerably milder than its two predecessors. The spike upward of inflation and interest rates was quite brief. The resulting contraction produced only a modest decline of national output and employment. Slow and steady monetary growth for the past four years means inflation will be in the 3-4% range this year and next and is likely to average below 4% for the next five years.

Market interest rates are at their lowest levels in four years and are not forecast to rise sharply in the next five years. The U.S. dollar is firm on foreign-exchange markets. The U.S. trade and current-account deficits have been shrinking since 1987. Unlike the expansion of the 1980s, export and import-competing industries will continue to be relatively strong in the 1990s.

Major Domestic Trends. In the 1980s real defense spending rose; in the 1990s, real defense spending will decline. Sectors, regions and industries that prospered during the previous defense buildup will be adversely affected by sustained defense cuts.

A combination of inflation psychology, tax incentives, and adequate financing produced a commercial building boom in the 1980s. The stock of office buildings, hotels and retail centers increased dramatically to levels that will be adequate for many years. Meanwhile, spending on associated infrastructure lagged, but has moved higher among national priorities for the 1990s. Transportation, water supply, waste disposal, education, and health-care facilities will require additional resources into the mid 1990s.

Excellent growth prospects in this expansion can be expected in telecommunications; pharmaceuticals and other health-care-related industries; software development and computer-systems-support services; the "leisure group" of industries—travel, tourism, entertainment & recreation; food processing; environment-related technologies & construction; and production of multi-family housing in the high-growth regions of the western states.

International Trends. Economic liberalization will continue to spread in the 1990s as the transition from socialism to capitalism gains momentum. While the 1980s was a period of turmoil and decline in Latin America, the 1990s will bring greater prosperity. In Eastern Europe, the 1980s was the last of several lost decades; the 1990s is the beginning of a new era of expanding opportunities and rebuilding.

Western Europe suffered from "Euro-pessimism" in the first half of the 1980s, then became the industrialized world's locomotive for economic growth as the decade drew to a close. More balanced growth with low inflation can be expected in the 1990s.

In Asia, the newly-emerging economic tigers of Indonesia, Thailand, and Malaysia will in the 1990s follow the successes in the 1980s of Korea, Taiwan, Singapore, and Hong Kong. High levels of capital formation in Japan indicate continued high growth and export competitiveness.

First Interstate Territory

The western regions of the U.S. lagged behind the rest of the country in the economic expansion of the mid 1980s. In the 1990s, the FI Territory states will lead the nation in terms of income and job growth. The western migration is partly stimulated by depressed economies in the northeastern regions of the country and partly by the renewed vitality of the Southwest and Northwest. Small-population states of the west—especially Nevada, Idaho, and Utah—will grow rapidly. Arizona and Texas have resumed their roles as faster growing large states. California's growth will be slightly faster than the nation.

The Pacific Northwest will record the strongest growth in the five-year period, followed by the Rocky Mountain region and the Pacific Southwest. The Southern Tier and North Central region will grow slightly faster than the national average.

June 10, 1991

The U.S. Economy

Near Term

Economy in Transition

The National Bureau of Economic Research, the official arbiter of cyclical turning points, determined that the expansion beginning in November 1982 ended last July. The same organization is likely to ultimately declare that the recession ended sometime during the second or third quarter of 1991.

Economic indicators will show mixed reports even as the recovery begins to take hold. All regions and industries will not turn up at the same time or pace. Economists and other analysts tend to underestimate the strength of upturns, while there is a general anxiety about "what will bring the economy out of recession?"

Such a concern is misplaced. Market-based economies have a natural tendency to expand, based on increases in population, productivity, capital, and technology. External shocks, such as changes in oil prices or shifts in monetary policy, can temporarily interrupt a growth trend, but market economies will find a new equilibrium.

The recession which began last fall was triggered by the combination of tight monetary policy and the Middle East crisis. The removal of those depressants should allow growth to resume. Congress and the Administration are likely to continue to avoid tax cuts or spending increases to "prime the pump" unless the recession persists well into the second half of 1991. Federal Reserve policy has become more expansive, with a sizable increase in monetary growth, but the Fed appears more concerned than in the past about overreacting to current weakness.

Too Much Debt or Too Little Credit?

While one major concern about the U.S. economy is that there is too much debt, another worry is that there is too little credit. Although either problem may be an issue for different segments of the economy, neither is sufficient to block a general economic upturn. The burden of government debt will keep growth lower than could otherwise be achieved. Many households and business firms will be trying to strengthen their balance sheets. The "credit crunch" problem mainly appears as a regional issue (the Northeast) and an industry problem (builders without sufficient equity). Recent surveys show that only about 5% of small business firms see credit availability as their primary constraint.

We expect the economy to expand at an annual rate of 3-4% in the second half of 1991, followed by a gain of about 3% in 1992. Housing and real estate are assuming their traditional roles as leading edges of the recovery, although housing starts will only total about 1.15 million units in 1991, down about 3% from last year's results. Homebuilding should show a stronger year in 1992 with a total of 1.41 million starts.

Consumer spending is likely to expand moderately as consumers attempt to save a larger share of their incomes in 1991 and 1992. Total sales of autos and light trucks will reach only 12.6 million units this year, down 9% from 1990. Sales in 1992 should rise to about 14 million vehicles, a gain of 12%.

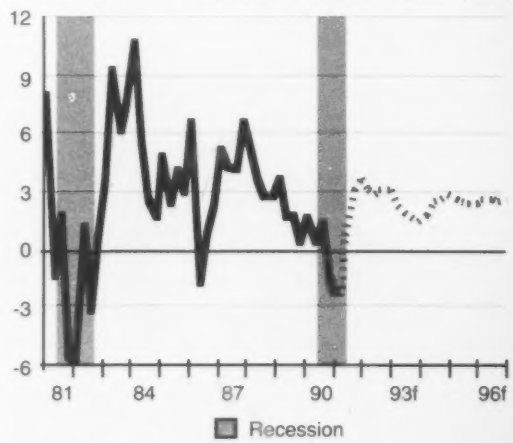
Although business spending on new equipment dropped in the first quarter of 1991, that decline is likely to be temporary. Gradually improving cash flows and lower interest rates should reactivate plans to improve productivity. The major swing factor in the economy will involve a rebuilding of inventories. Stocks were slashed aggressively in both last year's fourth quarter and the first quarter of 1991. A change from inventory liquidation to even modest stock accumulation could cause a large jump in real GNP.

Nonresidential construction will be the weakest sector of the economy in the early stages of recovery, as new and completion work on offices, hotels, and other commercial buildings continues to decline. Although public construction will be strong, defense spending cuts and budget pressures at all levels will restrain government outlays.

Following several months of job losses, we expect employment to gradually expand again in the second half of 1991 and in 1992. The unemployment rate, after reaching an average of 6.4% in the first quarter of 1991, is likely to drift down to 6.0% by the end of this year and 5.3% by year-end 1992. Economic after-tax profits (excluding inventory gains and valuing depreciation on a replacement cost basis) will decline another 1% this year, but improving margins and volume should push profits up 9% in 1992.

Recession/Recovery: 90s vs. 80s

(Real GNP, annualized percent change from prior quarter)



MAJOR ECONOMIC INDICATORS

	QUARTERLY												4th QUARTER					
	1990				1991				1992				% Change			% Change		% Change
	I	II	III	IV	I	II	III	IV	I	II	III	IV	1990	'90/'89	1991	'91/'90	1992	'92/'91
	Actual				Forecast				Forecast				Actual		Forecast			
GROSS NATIONAL PRODUCT (Billions of $, annual rate)	5375.4	5443.3	5514.6	5527.3	5562.3	5622.5	5711.7	5810.5	5902.7	5992.2	6084.4	6175.1	5527.3	4.5	5810.5	5.1	6175.1	6.3
% Change, annual rate	6.7	5.1	5.3	0.9	2.6	4.4	6.5	7.1	6.5	6.2	6.3	6.1						
REAL GNP (Billions of 1982 $, a.r.)	4150.6	4155.1	4170.0	4153.4	4123.9	4133.2	4165.9	4203.7	4236.9	4268.4	4302.1	4335.2	4153.4	0.5	4203.7	1.2	4335.2	3.1
% Change, annual rate	1.7	0.4	1.4	-1.6	-2.8	0.9	3.2	3.7	3.2	3.0	3.2	3.1						
REAL FINAL DOMESTIC SALES* (Billions of 1982 $, a.r.)	4195.2	4189.1	4210.5	4191.1	4.45.4	4152.2	4170.4	4195.9	4225.4	4254.1	4283.7	4313.1	4191.1	0.6	4195.9	0.1	4313.1	2.8
% Change, annual rate	2.7	-0.6	2.1	-1.8	-4.3	0.7	1.8	2.5	2.8	2.7	2.8	2.8						
REAL CHANGE IN INVENTORIES (Billions of 1982 $, a.r.)	-2.2	9.5	4.7	-26.4	-20.7	-15.0	-4.0	8.0	12.0	15.0	18.0	20.0	-26.4	N/A	8.0	N/A	20.0	N/A
GNP DEFLATOR (1982=100)	129.5	131.0	132.2	133.1	134.9	136.0	137.1	138.2	139.3	140.4	141.4	142.4	133.1	4.0	138.2	3.9	142.4	3.0
% Change, annual rate	4.8	4.7	3.7	2.8	5.5	3.4	3.2	3.3	3.2	3.1	3.0	2.9						
CONSUMER PRICE INDEX (1982-84=100)	128.2	129.4	131.6	133.8	135.0	135.9	137.2	138.5	139.7	140.9	142.1	143.3	133.8	6.2	138.5	3.5	143.3	3.5
% Change, annual rate	7.5	3.8	7.0	6.9	3.6	2.6	3.9	3.8	3.6	3.5	3.6	3.4						
AUTO SALES (Millions, annual rate)	9.8	9.5	9.7	9.0	8.2	8.3	8.9	9.4	9.7	9.8	9.9	10.0	9.5**	-4.1	8.7**	-8.2	9.9**	13.0
HOUSING STARTS (Millions, annual rate)	1.43	1.20	1.13	1.04	0.91	1.05	1.30	1.36	1.38	1.41	1.42	1.43	1.19**	-13.3	1.15**	-3.2	1.41**	22..1
INDUSTRIAL PRODUCTION (1987=100)	108.3	109.4	110.5	108.5	105.9	105.9	106.7	107.7	108.7	109.7	110.6	111.5	108.5	0.4	107.7	-0.7	111.5	3.5
% Change, annual rate	0.7	4.1	4.1	-7.0	-9.2	0.0	3.0	4.0	3.7	3.5	3.4	3.3						
NONFARM PAYROLL EMPLOYMENT (Millions)	109.9	110.5	110.7	110.2	109.5	109.2	109.6	110.1	110.7	111.3	111.9	112.4	110.2	0.9	110.1	-0.1	112.4	2.1
UNEMPLOYMENT RATE, ALL WORKERS (Percent)	5.2	5.3	5.5	5.8	6.4	6.5	6.3	6.1	5.9	5.7	5.5	5.3	5.3	N/A	6.1	N/A	5.3	N/A
ECONOMIC PROFITS AFTER TAXES (Billions of $, annual rate)	167.0	173.4	161.6	162.4	160.0e	162.0	165.0	168.0	172.0	176.0	180.0	184.0	166.1**	-5.9	163.8**	-1.4	178.0**	8.7
% Change over year ago	-6.7	-4.0	-9.7	-3.0	-4.2	-6.6	2.1	3.4	7.5	8.6	9.1	9.5						
MONEY SUPPLY M2 (Billions of $, a.r.)	3252.7	3284.4	3308.8	3326.4	3356.3	3410.8	3460.8	3510.8	3560.6	3608.6	3656.3	3701.2	3326.4	3.8	3510.8	5.5	3701.2	5.4
% Change, annual rate	6.3	4.0	3.0	2.1	3.6	6.6	6.0	5.9	5.8	5.5	5.4	5.0						

NOTE: All quarterly series are seasonally adjusted; % change, annual rate calculated from prior quarter; calculations based on unrounded data; a.r. = annual rate; e=estimate. *Excluding Commodity Credit Corp. purchases

**Annual total; N/A = Not applicable

FORECAST OF INTEREST RATES

(Quarterly average)

	1990				1991				1992			
	I	II	III	IV	I	II	III	IV	I	II	III	IV
Short-Term	Actual					Forecast						
Fed Funds (Overnight)	8.25	8.24	8.16	7.74	6.43	5.80	5.80	6.06	6.25	6.46	6.64	6.81
Treasury Bills (3-month)[1]	7.76	7.75	7.48	6.99	6.02	5.52	5.49	5.63	5.75	5.96	6.14	6.33
CDs (3-month, secondary)	8.24	8.33	8.04	7.97	6.71	5.96	5.95	6.21	6.40	6.61	6.79	6.98
Eurodollar (3-month)	8.28	8.34	8.05	7.99	6.76	5.99	5.97	6.23	6.42	6.63	6.81	7.00
Prime Rate	10.04	10.00	10.00	10.00	9.19	8.67	8.50	8.50	8.50	8.50	8.75	9.00
Long-Term												
U.S. Government Bonds (30-yr)[2]	8.44	8.65	8.80	8.55	8.20	8.13	7.95	8.00	8.05	8.05	8.10	8.15
Corporate Aaa (Moody's)	9.19	9.40	9.40	9.29	8.93	8.80	8.69	8.74	8.80	8.80	8.85	8.90
Mortgage Rate (Fixed)[3]	10.12	10.34	10.11	9.95	9.50	9.43	9.37	9.42	9.48	9.48	9.53	9.58

(1) Bank discount basis (2) Yields adjusted to constant maturities (3) Contract rates on first mortgages, conventional market

Financial Markets Welcome Lower Inflation

After oil prices helped push up consumer prices 6.2% in 1990 (fourth quarter to fourth quarter), we expect inflation to subside to only 3.5% both this year and in 1992. Oil prices are likely to stabilize at an average of about $21 per barrel this year in terms of the West Texas Intermediate benchmark, 14% below last year's level. We assume that oil prices will average about $20 a barrel in 1992. Adherence to a strict monetary policy during the past two years will be the primary constraint on inflation through the end of next year. M2 (currency, checking & savings accounts, and small CDs) grew a moderate 4.7% in 1989 and only 3.8% in 1990. This tightness in monetary policy has limited the upward pressure on prices and wages in most sectors of the economy. Inflation is also typically constrained in the early stages of recovery as improving productivity helps to hold down unit labor costs.

Unless the economy shows new signs of deterioration, short-term interest rates may remain fairly flat through early fall, as the Fed ensures that the recovery process is under way and as inflation remains subdued. M2 growth is likely to be 5.5% in 1991, an increase in the upper part of the Fed's target range of 2.5-6.5%. We expect the bank prime rate to remain at 8.5% through the balance of 1991. As the economy gathers momentum in the second half of 1991 and in 1992, short-term interest rates will gradually move higher. The federal funds rate is likely to rise to 7.0% by the end of 1992.

Long-term interest rates will reflect primarily changes in inflation expectations. If consumer and producer price reports remain favorable, as we anticipate, the yield on 30-year government bonds could break below 8.0% for a few months this year. The long-bond yield is likely to be back to about 8.0% at the end of 1991 and then rise gradually along with short-term rates in 1992. Although mortgage demand will be strong, the easing in long-term rates should help push 30-year fixed mortgage rates down to about 9.3% by midyear from 9.5% in the spring. Mortgage rates are likely to be about 9.4% at the end of 1991 and 9.6% at year-end 1992. The 1991-92 period will contrast significantly with the prior three years when fixed-rate mortgages were 10% or higher for most of the period.

Medium Term

How Durable an Expansion?

The expansion promises to be at least as long as the upswing which started in November 1982. The 1982-90 expansion was the second longest in history, with its 92 months only exceeded by the 106 months of the 1961-69 period.

The economy in the second quarter of 1991 is on a sounder base than existed in late 1982. Interest rates are substantially lower now than at the end of the previous recession. The current bank prime rate of 8.5% contrasts with the 11.5% level at the beginning of the last expansion. Recent mortgage rate levels of around 9.5% are a striking difference from rates of close to 14% in late 1982.

A lower unemployment rate in the present cycle will mitigate political pressures to aggressively stimulate the economy. The jobless rate reached nearly 11% at its peak in late 1982, helping to prompt an average annual increase of nearly 10% in the money supply (M2) in the 1982-84 period. In contrast, we estimate that the unemployment rate will remain below 7% in the current cycle and that M2 growth will average a more moderate 5% in the 1991-93 period.

In contrast to the last expansion, no major changes in tax structure or incentives are likely in at least the first part of the current upswing. Greater certainty is vital to various business decisions. External pressures to increase defense spending have diminished, freeing resources for other purposes. Market economies have displaced many centrally-planned regimes throughout the world, which should help prospects for U.S. trade and investment.

Certain legacies of the 1980s will retard the

expansion of the 1990s. Both fiscal 1991 and 1992 will show deficits of about $300 billion. By fiscal 1996, however, a reasonable chance exists that the deficit will be under $100 billion. Outlays necessary to close failed S&Ls and resolve the thrift industry problem are currently contributing close to $100 billion annually to the overall deficit. By 1996, asset sales should provide a small positive contribution, partly offsetting deficits in other areas of the budget. Although the budget process adopted last fall still needs to be tested more fully, spending curbs should be at least partly successful. Continued economic growth could also help push the deficit down to about $90 billion by fiscal 1996. Such a deficit would represent 1.2% of GNP in contrast to an estimated 5.5% for fiscal 1991.

Granting of favorable tax incentives for nonresidential construction and their subsequent revocation have helped spawn a general excess of office and other commercial buildings. Office vacancy rates in many areas are 20% or higher, and certain markets confront a five-to-six year supply of vacant space. Nevertheless, office vacancy rates are beginning to drift downward and that process should continue.

The 1980s as a whole were characterized by rapid employment growth, with a total of 22 million jobs added during the past expansion. The corollary, however, was poor productivity performance. Companies are likely to hire at a more modest pace in the coming upturn and make more efficient use of computer and other technologies to boost productivity.

Policy and Demographic Framework

Economic policies should generally be more consistent than during the 1980s. We expect monetary policy to avoid the "stop-go" trends experienced at various times in the past. Defense spending is likely to decline at a relatively steady pace of about 4% per year in real terms. Federal taxes are unlikely to change substantially, but financially strapped states and localities can be expected to raise various taxes and fees.

ECONOMIC PROJECTIONS

	Fourth Quarter		Annual Average	
	Real GNP*	Consumer Prices*	Federal Funds	30-year Govt. Bonds
	(Percent)		(Percent)	
1990 actual	0.5	6.2	8.10	8.61
1991	1.2	3.5	6.02	8.07
1992	3.1	3.5	6.55	8.09
1993	1.9	3.6	7.50	8.00
1994	2.6	3.8	7.10	7.75
1995	2.6	3.6	7.00	7.55
1996	2.7	3.8	6.90	7.50

*Change over prior year

Industries are not expected to be re-regulated, although financial institutions will be closely monitored. Legislation could be enacted requiring companies to provide certain benefits, such as health insurance, for their employees. Environmental or safety laws already on the books will be enforced, while new legislation may be drafted.

With less emphasis on external threats, more attention will be directed to improving human capital (educational system) and public infrastructure (roads, bridges, and airports). Efforts to improve education through greater competition are likely. Market pricing may be introduced to utilize transportation networks more efficiently, while specially earmarked revenues and bond funds will support substantial public investment.

Changing demographics in the early 1990s will affect spending, saving, and productivity performance. The fastest growing population segment in the next five years will comprise those 45-54 years old. This group will be changing from an emphasis on spending during the past several years to a greater focus on saving—in sizable part for retirement. A more experienced work force should also help raise productivity.

Economic Landscape of the 1990s

Our forecast is for no "booms" or "busts" during the five years through 1996. Real economic growth is expected to average about 2.6% per year. Growth will be faster than that average early in the expansion, while Fed tightening in 1993 to constrain inflation could briefly slow business activity. The economy is generally likely to follow a "narrower corridor," avoiding swings into periods of high growth and sharp decline. The next five years are likely to resemble the 1960s more closely than the 1980s.

Unemployment will drift down in the early part of the expansion and then probably hold at close to 5% of the work force, representing essentially full employment for the U.S. economy. Relatively moderate monetary growth should help hold inflation, measured by consumer prices, to an average of about 3.7% over the five years through 1996. We assume that oil prices will remain flat in real terms after 1992, rising in nominal terms only with the general pace of inflation. A sustained period of lower actual inflation should help reduce the inflation premium in long-term interest rates. By 1995, yields on 30-year Treasury bonds will be down to about 7.5%. Short-term interest rates will reflect the pace of economic growth as well as inflation, rising into 1993 before falling back in 1994 in reaction to economic slowing.

Reduced volatility in the economy should cause consumers and business firms to take a longer-term view of the economy. Combined with the impact of demographic trends, the result should be higher rates of saving and investment than experienced in the 1980s.

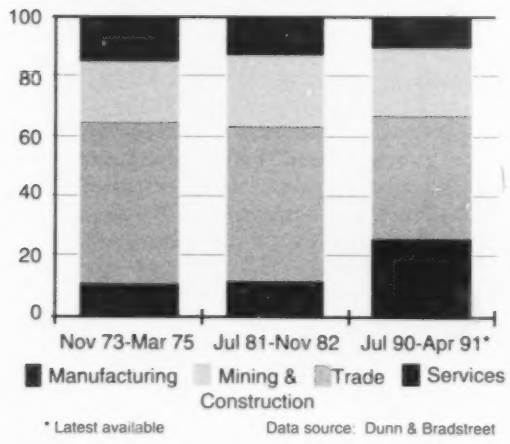
Industry Perspective

Near Term

As the economy gains strength through the rest of 1991 and into 1992, certain U.S. industries will recover faster than others. For some, such as the motor vehicle, airline, steel, forest products, and retail industries, recovery will be slow due to weakened demand, competitive shakeouts, and industry-wide restructuring. Other segments, including health care, pharmaceuticals, food processing, and some service-sector industries, showed gains in employment and output over the last several quarters and are likely to continue to expand during the next two years.

The composition of business failures in the latest downturn has differed somewhat from the 1973-75 and 1981-82 recessions. Efforts to improve inventory management and overall efficiency have resulted in a steady decline in the manufacturing sector's share of failures over the last two downturns. Meanwhile, the share of failures in services has more than doubled during the most recent downturn (see accompanying chart). The increase in services failures should be interpreted with some caution, as the nature of this sector has changed considerably since 1980 (the 1990-91 data are adjusted for comparability to earlier periods). Failures in wholesale and retail trade have also exhibited a considerable decline over prior recessions, while the share of failures in mining and construction is slightly lower than in 1981-82.

Services Failures Loom Larger in 1990-91 Recession
(Percent share of total failures)

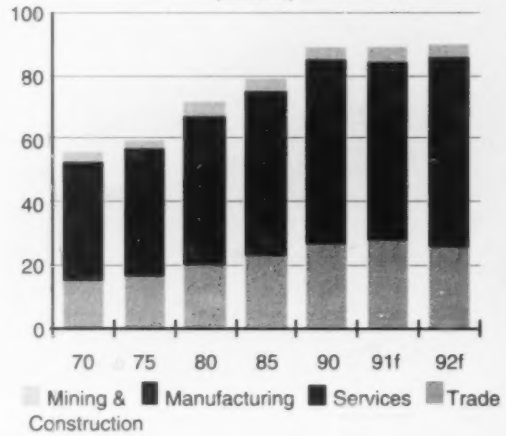


* Latest available

Data source: Dunn & Bradstreet

Recent trends in the composition of employment across various sectors of the U.S. economy are likely to continue for the next two years. The accompanying chart demonstrates the U.S. shift toward a more service-oriented economy. While the share of total employment in services is likely to level off over the next several years, certain service industries should show significant growth, especially in the areas of health care, business services (such as software design and computer-systems integration), and environmental engineering and consulting services (see box on page 8).

Services' Share of Employment Leveling Off
(Millions)



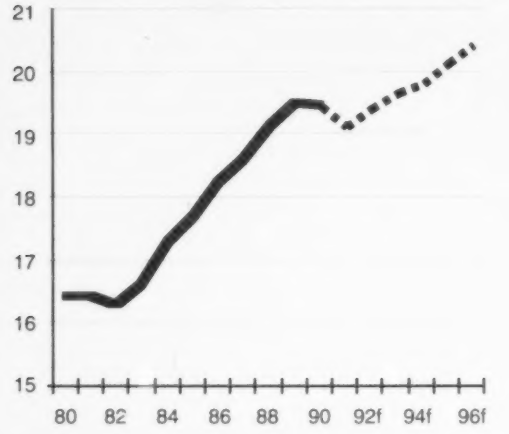
Medium Term

Several factors will help shape industry trends during the next five years. These include shifts in demographics and real incomes as the baby-boom generation matures, technological advances, the revitalization of the nation's infrastructure, and an increasingly unified global economy. EC '92 and other attempts to develop common standards for international commerce and to lower trade barriers should benefit many industries.

Demographics: More Money, Different Demands

As the number of individuals in the high-income-generating age group of 45-64 increases steadily through the 1990s, opportunities will develop for certain industries that are able to cater to this group's demands. The chart that follows illustrates how real income per capita should change over the next several years. With real incomes increasing beyond 1991, opportunities should expand for superior-quality-goods manufacturers and for providers of leisure goods and services, as a wealthier population is more likely to demand these types of goods and services. The recent growth in the health care industry should also continue, since expenditures on health care and income levels show some positive correlation. Finally, growth in the various travel and tourism industries is also likely with an older and wealthier population.

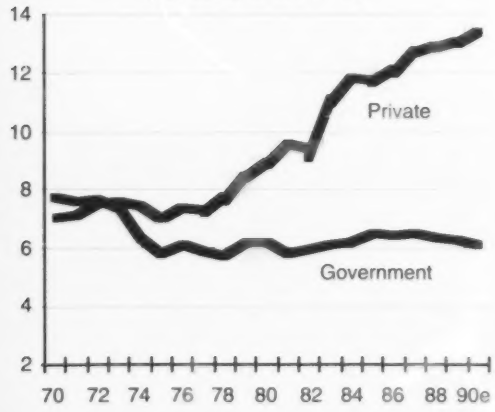
Aging "Baby Boomers" Make for a Wealthier Nation
(Personal income per capita, thousands of 1991 dollars)



Technological Challenge for the 1990s

U.S. industry, especially in the area of high-tech electronics, very often has been the victim of its inability over the last ten to fifteen years to successfully commercialize new technology. This development is explained in part by the fact that a majority of new innovations in high-tech electronics in this country have been designed for defense applications, while such competitors as the Japanese have focused their development efforts on products designed for the mass consumer market. The U.S. government's contribution to research and development funding in the area of electronics has lagged behind that of private companies (see chart).

Government Funding Lagging in R & D for Electronic Technology
(Billions of 1991 dollars)



This is a frequently mentioned disadvantage of the U.S. industry relative to its Japanese counterpart, which receives significant R&D assistance through government grants and equipment donations.

Although real defense spending is expected to continue to decline by some 4% each year over the medium term, high-tech electronics are likely to receive a larger share of government outlays. The challenge for the U.S. electronics industry is to pursue more aggressively the development and marketing of spin-off consumer technologies.

Increased Expenditures on Infrastructure

The federal government budget proposal for fiscal 1992 includes a 39% increase in spending authority for the nation's aging interstate highway system. Approximately $88 billion is expected to be spent over the next five years for highway construction and rehabilitation. In addition, the government has authorized a sizable increase in spending for bridges, mass-transit systems, and infrastructure related to air travel. These plans are welcome news to U.S. industry which needs modern, well-kept transportation systems to support supply and distribution channels for both domestic and import/export activities.

Another vital area of infrastructure is education. Businesses will continue to find themselves in the position of having to provide workers with training in rudimentary skills unless the effectiveness of the nation's schools improves significantly. Supplying workers with basic skills not only increases costs for U.S. industry, but the lower overall quality of its work force limits its ability to compete effectively internationally.

Towards a Unified Global Marketplace

Many industries in this country have been anticipating the formalization of the European Community in 1992 for several years. As more domestic companies expand into foreign markets, several issues emerge regarding the standards and regulations of international commerce. The robustness of domestic copyright protection in an international marketplace is one such issue that has become increasingly significant. Unless proper steps are taken to ensure the safety of intellectual property rights across international borders, future innovation and its attendant benefits may be severely curtailed.

This problem has been especially obvious in the areas of electronic circuits and components (such as semiconductors), computer software, and pharmaceuticals. In these high-tech industries, innovators rely heavily on copyright protection to recoup the significant amounts of capital they invest in the research and development stage of production. When a foreign firm is able to "reverse-engineer" these products and quickly produce a relatively cheap "knock-off," the innovating firm loses its ability to recapture its investments in R&D.

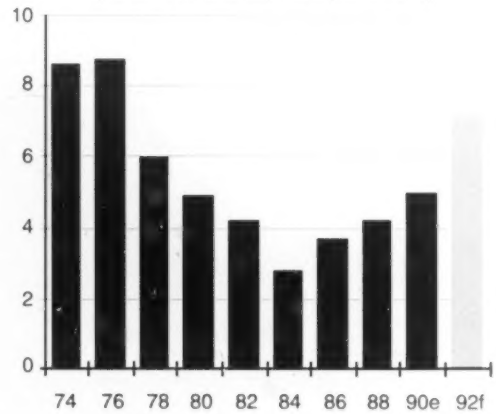
POLLUTION ABATEMENT IN THE '90s: PAIN OR GAIN FOR U.S INDUSTRY?

The last decade of this century is shaping up to be a period of increasing government attention toward a cleaner environment. Recent amendments to the Clean Air Act, or CAA (originally passed in 1970 and amended in 1977 and again in 1990), and other legislation, including the Comprehensive Environmental Response Compensation and Liability Act (CERCLA or "Superfund") passed in 1980 and the Resource Conservation and Recovery Act of 1976 (RCRA), will continue to define the standards of pollution abatement and cleanup for U.S. industry.

As the accompanying chart indicates, pollution-abatement expenditures as a percentage of total capital outlays declined from mid 1970 to mid 1980 as those industries affected by the regulations set in the early 1970s completed their investments in pollution-control capital. With the amendments to CERCLA and RCRA in the mid 1980s, pollution abatement expenditures began to rise once again.

U.S. Industry's Expenditures on Pollution Control Rising Again

(Percent of total capital expenditures)



Estimates are that U.S. industry is spending some $32 billion annually on environmental cleanup and pollution abatement, with that amount expected to increase by $25-$50 billion through 2005. It is also highly likely that industry outlays for pollution control will continue to increase as a percentage of total capital expenditures, given the recent amendments to the CAA and the fact that the Environmental Protection Agency (EPA) continues to upwardly revise its cost estimates for the cleanup of hazardous waste sites under the Superfund legislation.

The 1990 Clean Air amendments are significant to U.S. industry because they reflect an acknowledgement by the federal government that market-based procedures for pollution abatement (specifically in the area of reducing emissions by electric utilities that cause acid rain) are superior to traditional regulatory approaches. Under the plan for reducing emissions, individual electric utilities are given certain emission allowances which they may then either use themselves or sell to other operators. This trading of emission rights will ensure that the desired overall level of pollution reduction will occur at the lowest possible cost. Those utilities facing the highest costs for pollution control will eventually hold (and use) the emission allowances, purchasing them from those utilities that can cost-effectively reduce their own emissions. Some studies have estimated that the cost savings from this market-based approach over a more traditional regulatory one (*e.g.*, the mandatory adoption of flue-gas desulfurization equipment at all existing plants) could range from 20 to 40%, or $2-$3 billion, annually.

One question for the medium term is which industries will be negatively affected by the "greening" of the economy and which stand to benefit. As mentioned, the electricity-generating industry as a whole will have to implement certain pollution-reduction procedures in order to meet new emission standards. Generators can switch to hard, low sulfur coal (which will raise transportation costs) or they may install expensive scrubbers or "fluidized bed combustion" technologies. The adoption of these measures will cost the industry approximately $7 billion annually.

Other industries likely to be adversely affected by the recent CAA amendments (as well as by pollution cleanup costs under CERCLA and RCRA) include steel, mining, rubber and plastics, pulp and paper, electronics, petroleum refining, pharmaceuticals and chemicals, and auto production. Given the unclear extent of indirect environmental liability for financial institutions and insurance firms under current legislation, these industries may also be forced to bear at least some of the costs of cleaning up hazardous wastes.

Waste management, pollution consulting and engineering services, and firms that can develop innovative, economical methods of reducing, treating and/or storing air, water, and solid wastes stand to benefit most from current and future environmental legislation. Industry experts expect service revenues for the environmental consulting and engineering industry to grow an average 15% per year through 1995, with considerable growth in the hazardous waste treatment and recycling industries also expected during this period.

Thus, although some industries may face higher costs over the medium term, other industries may benefit from, and new industries may develop in response to, increased pollution controls. Assuming that any future regulation with regard to pollution abatement employs an economically efficient, market-based approach, U.S. industry should be able to comply with and eventually benefit from such regulations.

Financial Institutions

Near Term

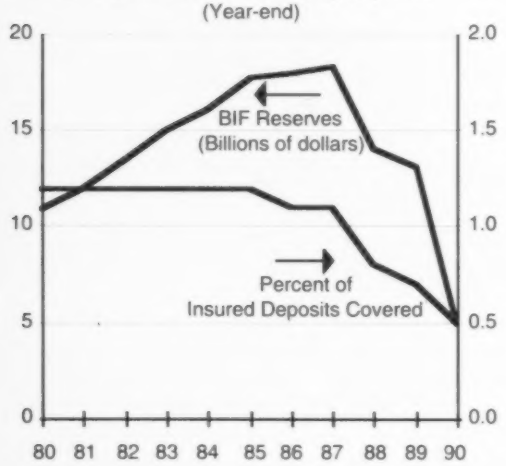
Banking Reform in Small Steps

Congress is considering the Treasury's bank-reform proposals to restructure, stabilize, and enhance the competitiveness of the nation's banks. The Treasury's proposals cover three broad areas: (a) bank powers and ownership, (b) regulatory agencies, and (c) deposit insurance. Of these, recapitalizing the Bank Insurance Fund (BIF) is the highest priority; also, some modification of the current system of deposit insurance will be enacted. The only other proposal that has a high probability of passage in 1991 is interstate branching. The other key proposals—allowing banks to enter securities and insurance markets, allowing commercial firms to own banks, and realigning the regulatory structure—are not likely to find adequate support and will be postponed.

Bank failures in the second half of the 1980s and in 1990 resulted in a severe depletion of BIF reserves, which plunged to $5.0 billion at the end of 1990 from a high of $18.3 billion in 1987. The General Accounting Office (GAO) contends that, unless premiums are raised substantially, the insurance fund will show a deficit of $5 billion by the end of 1991. The Federal Deposit Insurance Corporation's recent 18% increase in insurance premiums (from 19.5 cents to 23 cents per $100 of deposits) will take effect in mid 1991 and will cost the banking industry close to $1 billion annually. The GAO has recommended a special assessment of 40 cents per $100 of deposits on top of this in order to generate $15 billion of reserves for the BIF. The FDIC has suggested a special assessment of 30 cents per $100 of deposits. As the above chart indicates, the coverage ratio fell from 1.2% of insured deposits in 1980-85 to 0.5% in 1990.

Bank Insurance Fund Nearly Depleted

(Year-end)



Considerable support has developed to enact the interstate branching proposal this year. This measure is viewed as an important step to reduce the risk of failure by allowing greater regional diversification of bank investment, lending, and deposit-gathering activities. By improving economies of scale of large institutions, interstate branching would reduce operating expenses and enhance the competitiveness of U.S. commercial banks. Finance companies had more than $275 billion outstanding in business loans in 1990, more than twelve times their holdings in 1970. Money market funds had close to $348 billion in consumer savings in 1990, despite the fact that they were nonexistent in the early 1970s.

Interstate branching would also quicken the pace of consolidation within the banking industry, reducing the number of banks from more than 12,000 to under 10,000 by the mid 1990s and 8,000 by the end of this decade. Bypassing banks as a source of credit, corporations raised over $150 billion in commercial paper in 1990 compared with less than $8 billion in 1970. The potential value of interstate branching can be seen in the divergence in the number of bank failures by region over the 1988-90 period. There were 638 bank failures in the Southwest (energy loans), 185 in the Midwest (farm loans), 143 in the West (real estate and energy loans), but fewer than 20 failures each in the Southeast, Northeast, and Great Lakes regions. Data on nonperforming loans as a percent of assets show similar disparity. Geographical diversification could help banks reduce their overall risk.

Medium Term

'90s Better than '80s

For the U. S. banking industry, the '90s is likely to be a period of recapitalizing, restructuring, and redefining its role in the domestic economy and in global financial markets. The 1980s (especially the second half) turned out to be the most troubling time for banks since the catastrophic collapse of the system in the 1930s. Most of the problems experienced by banks in the 1980s will diminish in the present decade. Loan-loss reserves are being rebuilt and nonperforming loans are now declining. The improving trends of net interest margins, higher capital levels, a less constraining regulatory regime, and a more stable economy will enhance the competitiveness of banks.

Foreign bank inroads into the U. S. banking market should diminish in the '90s. Japanese banks, for example, have been weakened by declines in Japan's equity and real estate markets. Foreign banks raised their share of U. S. banking assets from less than 7% in 1980 to over 22% in 1990. This trend is not expected to continue in the '90s because of the reduced strength of the Japanese banks, the shift in

international focus towards opportunities in the European Community (EC), and the Basle Accord's elimination of the comparative advantage that some foreign banks enjoyed with respect to greater leverage.

Nonperforming loans escalated in the second half of the '80s, reflecting the combined problems in HLT (highly-leveraged-transaction) loans associated with the financing of corporate takeovers, remaining LDC (less-developed country) loans, and real estate portfolios of certain regions. Nonperforming assets (NPA) as a percent of total assets moved up from 1.6% in 1984 to 2.9% in 1990.

The largest 25 banks held over $60 billion in HLTs, representing 4.2% of their total assets in 1990 and trending down in the latter part of 1990. Nonperforming HLT loans, however, could rise during the 1991-93 period as large volumes (approximately $5 billion per year) of "junk bonds" are scheduled to mature during this period. A high default rate of junk bonds poses a direct risk for insurance companies, pension funds, and mutual funds. For large banks with substantial portfolios of HLT loans, this represents an indirect risk as weak corporate borrowers attempt to restructure their total debt. The default rate on HLTs has moved up to 9%, and the volume of junk bonds outstanding is now over $230 billion. After 1993, the HLT issue is likely to lessen as a major threat to bank credit quality and performance.

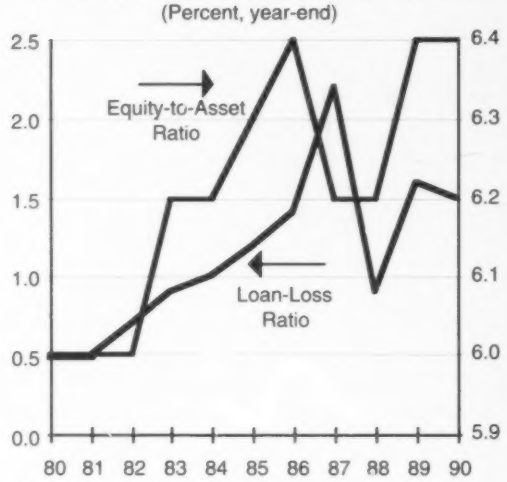
The LDC debt problem has eased appreciably since 1986, with total loans and commitments to LDCs held by the nine money-center banks falling to $39 billion in 1990 from $58 billion in 1986. Also, the overall exposure of these banks fell from 125% of capital to 71% over the same four-year period. Nonperforming real estate loans, especially nonresidential, are already declining at some of the large banks—a trend that could pick up depending on regional market conditions and the overall pace of growth in the economy.

The accompanying chart indicates that the capital position of the banking industry as a whole strengthened during the 1980s, with equity-to-asset ratios moving up from 6.0% in 1980-82 to 6.4% in 1989-90. As the deadline (year-end 1992) for meeting the risk-adjusted capital standards set down in the Basle Accord approaches, nearly 80% of the top 300 banks are already at the minimum 8% capital-to-asset level. With the recent emphasis on divesting bad assets and enhancing capital, large banks are augmenting their capital positions rapidly. This strategy will pay off in the '90s as many corporate and individual customers adopt a "flight-to-quality" attitude in choosing their banks.

Loan-loss provisions (measured as a percent of total loans) have become a critical indicator of a bank's financial condition. The improvement in capital is coming none too soon, as the federal "safety net" will shrink by legislative and regulatory mandate. The banking industry increased its loan-loss ratio (reserves as a percent of assets) from 0.5% in the early '80s to 1.5% in 1989-90—reflecting more realism regarding the potential for future losses.

Loan Loss Provisions Up, but Capital Improves

(Percent, year-end)



Banking in the early part of the 1990s will be characterized by the gradual but steady efforts of many institutions to work through the excesses and mistakes of the 1980s and to new approaches to manage risk and meet customer demands. As the middle of the decade approaches, more stable, well-capitalized, and more competitive banks should emerge. The lines of distinction between investment firms and commercial banks will become increasingly blurred. Banks will be challenged to offer a wider range of products (such as mutual funds and insurance annuities) to their customers. Businesses with limited direct access to capital markets, either because of their small size or high risk profile, will continue to be users of bank credit.

The survivors will be the low-cost producers that have successfully adopted new technology and achieved efficiencies, those that have established well-defined market niches, and those that have expanded financial services over a wider geographical base and consequently maximized the return on non-interest expense.

The International Economy

Near Term

Policy Remaining Tight in Industrial Countries

Monetary policies remain fairly restrictive in the major industrial countries outside the United States. The year-over-year increase in the Japanese money supply has fallen to under 4% recently, which will slow economic growth this year. Although the next move in Japanese interest rates is expected to be downward, the timing of such a cut by the Bank of Japan remains uncertain. Part of the rationale behind Japanese monetary policy is the desire by the authorities to see a definitive end to land-price speculation. Signs of slower economic growth have appeared, including reductions in industrial production and retail sales growth. Our expectation is that Japanese real GNP growth this year will be in the 3.0-3.5% range, compared with last year's rise of 5.5%.

In Germany, unification has distorted monetary data. Nevertheless, interest rates were progressively raised and currently are quite high in relation to Germany's still relatively low inflation rate of 2.7% (year over year) during this year's first quarter. The unification process is simultaneously raising investment needs and lowering net saving because of the higher government budget deficit, expected to reach 5% of GDP in 1991. This combination, in addition to the explicit policy objectives of the Bundesbank, is a further reason for the very high interest rates prevailing. The change in the investment/saving balance is also causing a rapid decline of Germany's current-account surplus. Some slowing in export growth in the near term, together with the rapid decline in economic activity in the eastern länder, will result in real GDP growth falling to under 3% this year, compared with last year's 4.5% rise.

In the rest of Europe, economic growth has generally slowed as well. The high interest rates in Germany resulting from the unification process have been transmitted through the European Monetary System to the other member countries of the European Community (EC). In the United Kingdom, a fairly severe recession resulting from efforts to tame an inflationary bout is being prolonged by the generalized high real interest rates. Growth has also slowed significantly in France and Italy.

Canada, the largest trading partner of the United States, has yet to see the beginning of a recovery from its recession, although some signs of a pickup in the housing market have appeared. Real GNP is anticipated to show a small decline this year, although a recovery is expected in the second half of the year. The Bank of Canada lowered interest rates significantly during the first several months of the year.

World Trade Growth Slows in 1991; Will Pick Up in '92

World trade is an important mechanism for transmitting real economic growth among different regions of the world. Because of the industrial-country economic slowdown in 1991, we expect the growth in the volume of world trade to decline, but the stronger economic expansion in 1992 should generate much more vigorous real trade growth. In addition, the price component will moderate substantially in 1991, as the data in the table show, before picking up in 1992.

WORLD TRADE

(Imports, percent change)

	1988	1989	1990e	1991f	1992f
Volume	8.6	6.8	4.3	1.2	4.3
Price	5.1	1.1	10.4	1.0	3.4
Nominal	13.9	8.0	15.2	2.2	7.8

Dollar Strong During 1991, Mixed in 1992

In comparison to December 1990 levels, the dollar strengthened about 15% against the deutschemark and 3% against the yen through mid May. Prevailing and expected economic conditions in the United States *versus* those abroad will cause the dollar to hold its value on the foreign-exchange markets or even strengthen somewhat for much of the remainder of 1991, and perhaps into 1992. The U.S. economic recovery should lead those in other economies currently in recession or those slowing, which should encourage investment in the United States leading to dollar strength. In addition, the U.S. trade deficit will decline in 1991 with continuing export expansion and slower import growth because of the recession and comparatively moderate recovery. A smaller deficit should be a positive factor for the dollar.

In late 1991 or early 1992, however, we anticipate that the dollar will lose strength against the yen, while it appreciates against the mark and other European currencies generally. Japan's recent investment splurge is beginning to wind down, but that investment will enhance Japan's position as a formidable export competitor in coming years. Japan's slowing economy means reduced import demand and a growing trade surplus in 1991 and well into 1992, which should add strength to the yen. A narrowing of the inflation differential between the United States and Japan should limit the yen's rise.

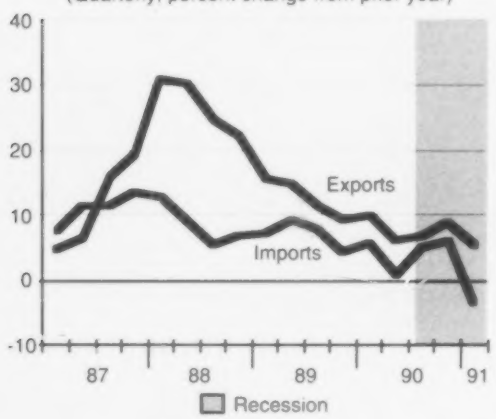
We expect that the mark will labor under the economic effects of German unification and a questionable outlook for Eastern Europe and the Soviet Union. Hence, the dollar should remain relatively strong against the mark for much of 1992. The U.S.-German inflation differential will virtually disappear and will add to the dollar's strength.

U.S. Recession Leads to Lower Trade Deficit

The recession that began last summer intensified in 1991's first quarter and has caused a substantial slowdown in U.S. import growth. With a continuing, large differential between export and import growth, we anticipate a decline in the 1991 trade deficit. Simultaneously, we expect the 1991 current-account deficit to fall by more than the improvement in the trade deficit alone. Other countries' contributions to the United States for the war in the Middle East should bring the transfers subaccount into surplus for the year. The exact amount of the surplus is currently unknown, because part of the contributions were "payments in kind," such as Saudi supplies of jet fuel.

U.S. Recession Widened Export-Import Growth Differential

(Quarterly, percent change from prior year)



With the U.S. economic recovery beginning around the second quarter of 1991, import growth will recover strongly in 1992. The differential between export and import growth will narrow sharply. We expect the current-account deficit to increase from 1991's level as the transfers subaccount returns to a deficit position.

U.S. CURRENT ACCOUNT

(Billions of dollars)

	1988	1989	1990	1991f	1992f
Trade balance	**-127.0**	**-114.9**	**-108.7**	**-92.8**	**-92.0**
Exports	320.3	360.5	389.3	412.6	443.7
Imports	-447.3	-475.3	-498.0	-505.4	-535.8
Services balance	**13.1**	**19.6**	**30.5**	**27.8**	**29.0**
Service exports	213.1	242.7	259.5	268.2	284.0
Service imports	-200.0	-223.2	-229.0	-240.6	-255.0
Transfers balance	**-15.0**	**-14.7**	**-21.1**	**15.0**	**-24.0**
Official	-10.7	-11.0	-17.0	20.0	-18.5
Private	-4.3	-3.8	-4.1	-5.0	-5.5
Current-Account balance	**-126.9**	**-110.0**	**-99.3**	**-50.2**	**-87.1**

Medium Term

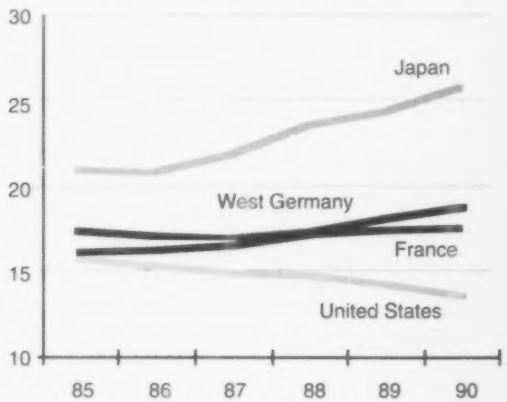
Characteristics of the Industrial-Country Expansion

The expansion of the industrial economies during the coming five years will differ from the expansion of the 1980s in some important respects, although some of the forces behind the pickup in industrial-country growth toward the end of the last decade will continue to be important over the medium-term outlook period. A few notable characteristics of the likely global economic environment during this time frame are discussed below.

1. *Pattern of growth.* During the late 1980s, private investment in plant and equipment was very strong. A major upward trend in capital formation occurred in Japan, Germany, and elsewhere in Europe. This strong investment growth, which has raised productive capacity, means that the growth of GDP during the coming few years should continue to be stronger in these economies. In addition, export competitiveness, particularly in Japan, is likely to remain strong.

Private Fixed Investment Leading Growth Outside U.S.

(Private fixed capital formation as percent of GNP)



2. *Inflation.* The central banks of several major countries, including Japan, Germany, and Canada, have taken a strong anti-inflationary stance during the past two years. This has headed off a resurgence of inflation in these countries as well as most of continental Europe. It is likely that inflation will not be a threat to the expansion abroad in the coming several years. The major risk would be politicization of monetary policy in Germany because of the costs of reunification. At present, this does not appear likely.

3. *Real interest rates.* The rise in investment and,

therefore, in potential growth in Europe and Japan means that the return on capital may have increased. This is part of the reason for the high level of real interest rates seen recently. High real rates may continue for some time in view of the level of investment demand in the industrial countries, Eastern Europe, the Middle East, and a number of developing countries.

4. *Capital flows*. The German current-account surplus is disappearing rapidly. German investment in other European financial markets should be reduced considerably in the coming period. Japan's current-account surplus has been reduced significantly from earlier years, and foreign-direct investment by Japanese companies has become a larger proportion of the capital outflows. As a result, Japanese financial investment in global capital markets is likely to be considerably less over the medium term than during the late 1980s.

5. *European currency unification*. By 1994, a European central bank may be established. This will be a prelude to the unification of currencies within the EC, which is envisaged for sometime later in the decade. Nevertheless, the development of a pan-European currency is already occurring, as the European Currency Unit (ECU) has taken on increasing importance in international banking and securities markets. The move toward a single currency in Europe could reduce the dollar's role as the dominant international currency, putting some constraint on U.S. domestic economic policy.

6. *International banking competitiveness*. With the imposition of the Basle Agreement on capital standards, potential asset growth for Japanese banks has been considerably reduced. As a result, lending by these banks will grow at much lower rates than during the past few years. This has implications for bank lending in other markets. In particular, it could mean higher spreads in U.S. corporate banking markets as Japanese bank asset growth slows. Japanese banks will still have an advantage because of a higher economic growth rate and a higher domestic saving rate than in the other industrial countries.

Solid World Trade Growth

World trade growth during the economic expansion of the 1990s will differ substantially from that of the 1980s. In the aftermath of the 1982 worldwide recession, the differential between the growth rates of the volume of world imports and prices shifted considerably from that of the late 1970s. During 1983-87, the volume of world imports increased 5.4% annually, while import prices rose only 0.8% per year. (For the 1976-80 period, prices soared 11.4% annually.) Much of 1983-87 period was influenced by deflationary conditions—non-energy commodity prices drifted downward until they fell sharply in 1985; energy prices declined until they collapsed in 1986.

For 1992-96, we look for the volume of world trade to increase somewhat faster than during the 1983-87 period. Collective industrial-country real economic growth will probably be little different from that during 1983-87, but more countries are participating in the world's market economy to a larger degree than during the earlier period; hence, the volume of world trade should expand faster, given an equal percentage of real economic growth. Prices, on the other hand, will be rising generally throughout the period, as opposed to falling as they did during the 1983-87 period. During the medium term, an overexpansion in commodity-production capacity, augmented by excess capacity following the recession, will not be as large as it was during the earlier period. Moreover, current energy prices are closer to those reflecting underlying market fundamentals, as opposed to the artificially high prices of 1979-80. Hence, the nominal value of world trade (volume times prices) will increase more rapidly during 1992-96 than the 1983-87 period's 6.2% per year, but less rapidly than the 18.4% rate during 1976-80.

During 1992-96, we will witness changes in world trade patterns resulting from regional-trade-bloc development. The European Community is well on its way to an integrated market for goods, services, and factors of production. In North America, proposed talks could lead to the formation of a free trade zone among the United States, Mexico, and Canada. The European Community has a population of 345 million, while that in North America would have a population of 365 million. These magnitudes are more than sufficient to meet any industry requirement for economies of scale.

Developments in Europe and North America have revived discussions in Asia about setting up a regional trade bloc, which would include Japan; the first tier of Asian newly industrial economies--Hong Kong, Taiwan, South Korea, and Singapore; the emerging second tier--Thailand, Malaysia, and Indonesia; and the Philippines and Brunei. The proposed trade bloc has capital surplus economies, economies willing to move uncompetitive industries offshore, a good natural-resource base, and a large consumer market of 520 million.

Although it appears that the world economy may evolve along lines of regional trade blocs, it does not necessarily imply increased barriers to world trade. In fact, trade barriers should generally decline as blocs lower impediments internally without raising them externally.

Eastern European Potential

The outlook for the USSR is particularly uncertain. Economic reform in that country has not yet gone far enough to establish the basis for sound economic growth. At the same time, the external financial position of the country has deteriorated alarmingly during the past year, making foreign creditors and potential investors wary of injecting

funds. Political pressures have increased, and there is potential for either an attempt to reimpose more central control or a breakup of the country. Even under the best of circumstances, it seems unlikely that the USSR will emerge as an important trading partner for Western countries during the forecast period. At the same time, negative developments could bring on currency weakness and slightly higher interest rates in Western Europe.

Most of the countries of Eastern Europe are moving in a clearer direction, with economic reform programs in some of them likely to produce results within the next few years. In particular, Poland, Czechoslovakia, and Hungary will be moving more closely toward Western economic systems during this period, and investment projects by Western companies are likely to increase. By the end of the five-year outlook period, trade volumes are likely to increase as well.

Developing Countries Joining the Global Market

Economic reform in a large number of developing countries is succeeding in integrating them into global markets. For the United States, Mexico is the third largest trading partner, and the latter country has shown significant progress in reforming its economy. As a result, trade with Mexico is likely to rise at a fairly rapid pace over the forecast period, with a possible free-trade agreement only accelerating the process. While the pace of economic reform in Latin America has varied, it is fair to say that the region holds considerably greater potential during the 1990s than during the 1980s, when the debt crisis caused the region's share of U.S. foreign trade to decline. Although external debt remains a major concern in a few countries, the debt problem will not be a problem for the international financial system during the next five years.

Elsewhere, Southeast Asia holds promise as the next group of developing countries to succeed in achieving rapid industrial growth. Investment from Japan, Taiwan, and Korea has been significant in this region, while economic policies have been favorable to private sector investment. In general, among developing countries, those that have liberalized economic policy the most hold the best prospects of attracting capital and, therefore, of achieving the highest growth rates.

Yen Strong during 1992-96

During 1992-96, we expect that the dollar will be stronger against the mark and other European currencies than against the yen. The economic problems arising from the unification of Germany will take several years to overcome. Germany will record substantially smaller trade surpluses for the period through 1996 in comparison to those in recent years. We look for the Bundesbank to pursue monetary policies that will stabilize and then lower inflation. Consequently, inflation differentials should not be a major determinant of the dollar/mark exchange rate after 1992. If Poland, Czechoslovakia, and Hungary commence strong economic growth, the mark would benefit. A serious deterioration in conditions in the Soviet Union would cause the mark to be weaker than otherwise.

Japan will continue to maintain its export competitiveness in goods in the medium term, while it opens its market to imports. The rate at which import growth occurs will be a major factor in determining the magnitude of its trade surplus--the larger the surplus, the stronger the yen. Japan's competitiveness will probably force developing Asian economies to depreciate their currencies against the yen to maintain export market shares. Just as we look for the Bundesbank to wage a successful war against inflation in Germany, we expect the Bank of Japan to keep inflation below a 3% trend rate, perhaps to less than 2%.

Challenges to U.S. Export Growth

We anticipate that net exports will continue to be a growth sector for the U.S. economy in coming years, but the strength will probably erode. The efficiencies resulting from increasing economic integration of the EC itself and between other European economies and the EC, in addition to a stronger dollar, will make U.S. exports to Europe less competitive over time. A stronger yen will encourage U.S. exports to Japan and other countries in Asia, but the pace at which these countries open their economies to imports will be important to U.S. export potential. The major U.S. comparative advantage is probably in agricultural goods and in a shrinking sphere of U.S. dominance for "high-tech" goods and technology itself. How well the United States is able to negotiate decreases in barriers to trade, including those for agriculture and services, and increased protection abroad for intellectual property rights will be important in determining the size of the U.S. current-account deficit in coming years.

The ability of countries to break the deadlock on the current Uruguay Round of the GATT negotiations will be significant in determining the evolution of regional trade blocs in the period through 1996, another important factor affecting U.S. export growth. An unsuccessful GATT negotiation could lead to a world with trade blocs that raise barriers to trade between blocs as opposed just to lowering barriers within blocs.

First Interstate Territory

Near Term

FI Territory versus Other Regions

First Interstate's banking territory (affiliates and licensees located in 19 states) will register stronger job and income growth in 1991-92 than the nation. These years will continue the trend of the previous two years when the Territory also outpaced the nation in job and income growth. In 1990, the seven fastest growing states in terms of jobs were all located in FI Territory: Nevada, Idaho, Utah, Washington, Alaska, South Dakota, and Hawaii.

The states served by First Interstate in 1989 chalked up an increase in average nonfarm job creation of 3.6% and 2.9%, respectively, despite a slowing national economy that slipped into recession in the second half of 1990. Higher oil prices helped to boost the energy sector in Texas, Colorado, Alaska, Louisiana, Oklahoma, and Wyoming. Higher farm prices stimulated job and income growth in such states as Iowa and Texas. Commercial aircraft orders sustained growth in Washington. Tourism fueled job expansion in Nevada, Hawaii, Utah, Colorado, California, and Texas.

By comparison, the severely weakened Northeast recorded a small job increase of just 1.0% in 1989 and saw employment decline by 0.7% in 1990. Local weakness in the high-technology, defense, textile, real estate, and financial industries contributed to the slump in employment in that region. The Southeast, hit by weakness in automobile production, textiles and apparel, lumber and wood products, and coal mining, still added jobs at a higher rate than the Northeast—3.1% and 2.2% in 1989 and 1990, respectively—but still did not match FI Territory's growth.

Medium Term

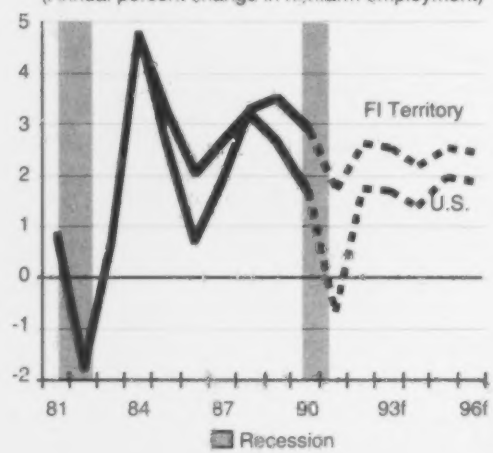
Economic Disparity of the 1980s

The economies of the states comprising First Interstate Territory displayed widely diverging performances during the 1983-90 expansion. The plunge in oil prices in 1986 to under $14 a barrel from over $30 at the beginning of the 1980s was devastating to the Southern Tier states (Texas, Louisiana, and Oklahoma) and to the Rocky Mountain region. The decline was magnified by the collapse of the building boom spurred by earlier expectations of continued high or rising energy prices.

The most energy dependent states—Alaska, Texas, Louisiana, Oklahoma, Wyoming, and Montana—suffered substantial employment declines in both 1986 and 1987. Colorado, which had a more diversified base, also lost jobs in 1986 and posted a minimal rise in the following year. In contrast, the nation as a whole achieved employment gains averaging nearly 2.5% per year during this two-year period.

The latter part of the 1980s represented a period of gradual recovery for the Southern Tier and Rocky Mountain region, helped by some firming of oil prices. By 1988, all of the constituent states experienced positive job gains. The Rocky Mountain states overtook the nation in terms of job growth by 1989, while the Southern Tier grew faster than the rest of the country in 1990.

FI Territory vs. U.S. Over the Cycle
(Annual percent change in nonfarm employment)



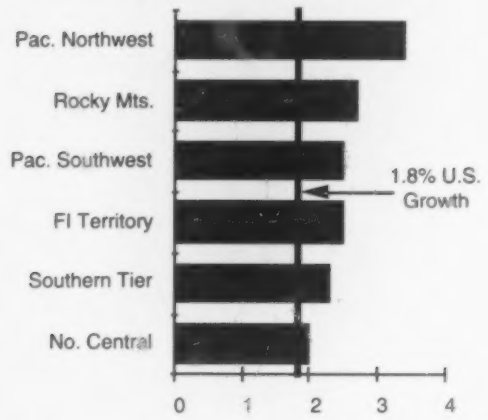
California's economy grew rapidly during the expansion beginning in 1983 until the combined effects of a national slowing and defense cuts hit in 1990. Arizona never posted a gain in employment of less than 2.5% throughout the expansion. Overbuilding in response to the growth surges of 8-10% early in the cycle, however, culminated in major problems in commercial real estate for these states. Meanwhile, growth in Western states such as Idaho, Nevada, Oregon, and Washington accelerated in the latter part of the expansion.

Less Divergence in the 1990s

The First Interstate Territory group of states is forecast to outpace the nation in terms of both employment and income growth in the five years through 1996. We expect that the Territory will show job gains averaging 2.5% a year during the 1992-96 period, versus a national average growth rate of 1.8%. Personal income growth in the FI banking market is projected at 6.7%, compared with a national trend of 6.1%.

The Pacific Northwest will be one of the strongest regions in the country, with sizable gains in Washington, Oregon, Idaho, and Alaska. Job growth for the region will average about 3.4% per year. Environmental concerns will constrain timber production, but international trade, commercial aircraft, population gains, and growth in high-technology firms will support the region.

Pacific Northwest Leads 1992-96 Growth
(Percent, annual average)

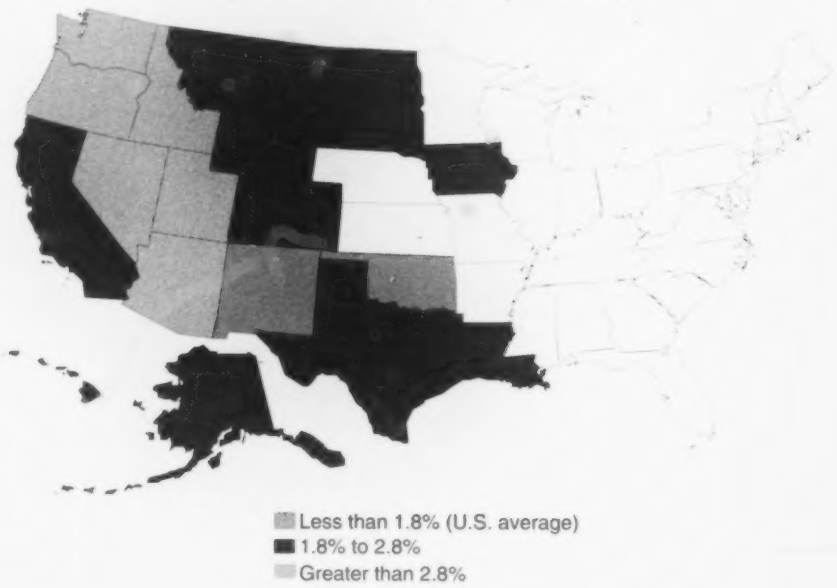


Our assumption is that oil prices will average about $20 a barrel in 1992 and then rise with inflation through 1996. Such a price level should support a considerable amount of energy exploration and development, although more marginal energy investments will not be pursued. Job growth is expected to average about 2.7% a year in the Rocky Mountain states and 2.3% in the Southern Tier area.

Farm conditions will remain vulnerable to federal subsidy cuts, export markets, and weather, but balance sheets in the agricultural sector have improved substantially. We look for job growth in the North Central area (Iowa, North Dakota, and South Dakota) to average 2.0% per year in the 1992-96 period, similar to the national average. Iowa and South Dakota have achieved sizable gains in their nonfarm sectors in recent years, and that trend can be expected to continue.

The Pacific Southwest will show a mixed performance over the medium term. California will grow only slightly faster than the nation. Arizona will post sizable job gains, but absorption of the oversupply of office space may require much of the forecast period. Nevada's explosive growth will moderate, but the state will still expand at a rate exceeding that of most states. Hawaii's boom is also likely to cool. Overall, however, the Pacific Southwest will show job growth averaging about 2.5% a year, a factor which will contribute to further gains in the region's population.

Several FI States to Register Strong Job Gains
(Annual average percent change, 1992-96f)



FI TERRITORY

NONFARM PAYROLL EMPLOYMENT FORECASTS

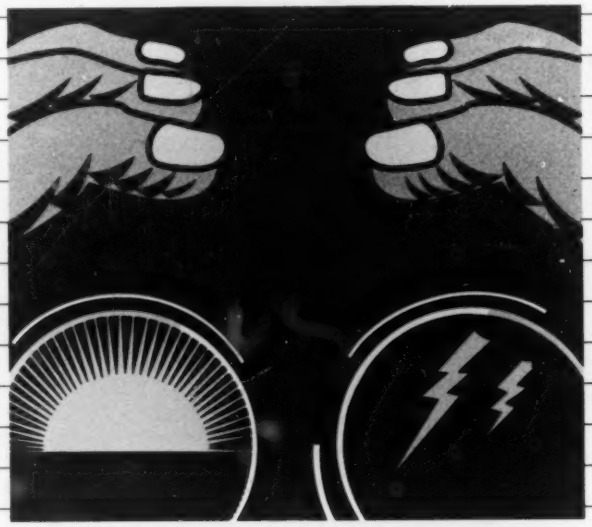
(Thousands of jobs)

	1991		1992		1993		1994		1995		1996	
	Level	% Change	Level	% Change	Level	% Change	Level	% Change	Level	% Change	Level	% Change
Alaska	243	2.6	250	2.9	257	2.7	263	2.4	271	2.8	278	2.6
Arizona	1,527	2.4	1,585	3.8	1,636	3.2	1,680	2.7	1,741	3.6	1,810	4.0
California	13,010	1.1	13,335	2.5	13,642	2.3	13,901	1.9	14,235	2.4	14,546	2.2
Colorado	1,555	2.4	1,595	2.6	1,638	2.7	1,677	2.4	1,718	2.4	1,757	2.3
Hawaii	539	2.1	552	2.5	565	2.4	578	2.2	591	2.3	603	2.1
Idaho	402	4.2	416	3.5	431	3.6	445	3.2	458	3.0	470	2.5
Iowa	1,238	1.1	1,259	1.7	1,281	1.8	1,301	1.5	1,327	2.0	1,353	2.0
Louisiana	1,645	3.2	1,696	3.1	1,735	2.3	1,770	2.0	1,814	2.5	1,850	2.0
Montana	304	2.1	311	2.4	318	2.4	325	2.0	332	2.2	339	2.1
Nevada	654	4.8	685	4.7	715	4.4	744	4.0	774	4.1	804	3.9
New Mexico	581	1.0	590	1.5	600	1.8	608	1.2	619	1.8	631	2.0
North Dakota	271	1.9	276	2.0	282	2.0	287	1.9	293	2.1	299	2.1
Oklahoma	1,198	1.0	1,218	1.7	1,240	1.8	1,259	1.5	1,280	1.7	1,302	1.7
Oregon	1,268	1.6	1,309	3.2	1,351	3.2	1,391	3.0	1,436	3.2	1,482	3.2
South Dakota	297	2.8	306	3.0	314	2.8	322	2.5	331	2.7	340	2.8
Texas	7,152	1.7	7,324	2.4	7,514	2.6	7,664	2.0	7,848	2.4	8,029	2.3
Utah	752	4.0	783	4.1	817	4.3	848	3.9	881	3.8	913	3.7
Washington	2,211	2.6	2,293	3.7	2,378	3.7	2,464	3.6	2,555	3.7	2,649	3.7
Wyoming	203	2.2	208	2.5	214	2.6	219	2.3	224	2.4	229	2.2
FI Territory	35,048	1.8	35,990	2.7	36,928	2.6	37,744	2.2	38,725	2.6	39,685	2.5
U.S.	109,612	-0.6	111,557	1.8	113,529	1.8	115,155	1.4	117,487	2.0	119,773	1.9

PERSONAL INCOME FORECASTS

(Billions of dollars)

	1991		1992		1993		1994		1995		1996	
	Level	% change	Level	% change	Level	% change	Level	% change	Level	% change	Level	% change
Alaska	12.8	7.1	13.8	7.4	14.8	7.2	15.8	6.9	16.9	7.3	18.1	7.1
Arizona	63.8	6.8	68.8	7.8	73.7	7.2	78.9	7.0	84.9	7.7	91.7	8.0
California	661.3	6.1	708.9	7.2	756.4	6.7	804.8	6.4	858.7	6.7	914.5	6.5
Colorado	66.0	6.5	70.4	6.8	74.9	6.4	79.7	6.3	84.7	6.3	89.9	6.2
Hawaii	24.1	7.3	26.0	7.8	27.8	7.2	29.8	7.2	32.0	7.3	34.3	7.1
Idaho	16.5	8.0	17.7	7.4	18.9	7.0	20.2	6.8	21.6	6.6	22.9	6.1
Iowa	50.5	5.4	53.6	6.1	56.6	5.7	59.8	5.6	63.4	6.1	67.3	6.1
Louisiana	64.8	6.7	69.1	6.7	72.9	5.4	76.7	5.3	81.2	5.8	85.5	5.3
Montana	12.9	6.4	13.7	6.8	14.6	6.3	15.5	6.1	16.5	6.3	17.5	6.2
Nevada	25.5	9.3	27.9	9.3	30.2	8.5	32.8	8.3	35.5	8.4	38.4	8.2
New Mexico	22.7	5.4	24.1	5.9	25.4	5.7	26.8	5.4	28.4	6.0	30.1	6.1
North Dakota	10.4	6.4	11.1	6.6	11.7	6.1	12.5	6.2	13.3	6.4	14.1	6.4
Oklahoma	51.2	5.3	54.3	6.1	57.4	5.7	60.6	5.6	64.1	5.8	67.8	5.8
Oregon	51.6	5.9	55.5	7.5	59.5	7.2	63.8	7.2	68.5	7.4	73.6	7.4
South Dakota	11.9	7.3	12.6	7.6	13.6	6.9	14.6	6.8	15.6	7.0	16.7	7.1
Texas	302.7	6.3	324.1	7.1	346.0	6.8	368.3	6.4	393.4	6.8	419.6	6.7
Utah	26.1	7.7	28.2	8.0	30.4	7.7	32.7	7.5	35.1	7.4	37.6	7.3
Washington	97.2	5.9	104.0	7.0	111.3	7.0	118.8	6.8	127.0	6.9	135.8	6.9
Wyoming	7.9	6.5	8.5	6.9	9.0	6.5	9.6	6.4	10.2	6.5	10.9	6.3
FI Territory	1,579.8	6.3	1,692.1	7.1	1,805.1	6.7	1,921.5	6.4	2,051.1	6.7	2,186.2	6.6
U.S.	4,827.6	3.9	5,133.3	6.3	5,433.6	5.9	5,746.9	5.8	6,111.4	6.3	6,490.3	6.2



First Interstate Bancorp